Islamic Economic Institutions and the Elimination of Poverty

Edited by
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To

Dr. Mohammad Omar Zubair

who is a source of inspiration for all those working in the field of Islamic economics and finance

بسم الله الرحمن الرحيم

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Preface

Even though the roots of Islamic economics lie in centuries-old Islamic principles, the development of Islamic economics as a scientific modern discipline started only in 1976 with the First International Conference on Islamic Economics held in Makkah, Saudi Arabia under the auspices of the King Abdul Aziz University, Jeddah. The series of International conferences organised thereafter by the International Association for Islamic Economics with the collaboration of some leading universities have made a significant contribution to the development of the discipline.

The 4th International Conference in this series was held at Loughborough University, UK during August 13-15, 2000. The theme of the Conference was "Islamic Finance: Challenges and Opportunities in the 21st Century". A major sub-theme of the Conference was "Islamic Approach Towards Poverty Alleviation". Altogether 24 papers were presented at the Conference. These were selected by the Academic Committee of the Conference based on a thorough pre-Conference review of the 74 papers submitted to it.

After the Conference, Edward Elgar Publishers, UK, showed an interest in publishing 10 papers presented at the Conference. In the interest of promoting the discipline in Western circles, the Steering Committee of the Conference decided to accept this offer. Accordingly, a volume entitled *Islamic Banking and Finance: New Perspectives on Profit-Sharing and Risk* has been published by them.

It was, however, considered necessary to publish a full record of the Conference through a suitable publisher. The Islamic Foundation, UK, which is undoubtedly one of the leading publishers in the field of Islamic economics and finance, has been chosen for this purpose.

The proceedings of the Conference are being published in two volumes. Twenty-four papers, including summaries of the 10 papers published by Edward Elgar Publishers, have been included in these volumes. Volume I entitled *Islamic Banking and Finance: Current Developments in Theory and Practice* contains 10 summaries, 8 full papers, Conference Communiqué and Conference Speeches. This present volume contains 6 papers on the sub-theme of the Conference. Since many Arabic terms have been used in the papers a cumulative glossary for the two volumes is included in each of the volumes for the benefit of readers.

Several people helped in preparing these volumes. Dr. M. Anas Zarqa, Chairman of the Academic Committee and Dr. Mabid Ali al-Jarhi, Director, Islamic Research and Training Institute (IRTI), Jeddah, guided me throughout the process. Dr. M. Umer Chapra, Research Advisor, IRTI, also gave several useful suggestions. Mr. Jaleel Asghar and Mr. Shaikh Amanul Hoque provided valuable secretarial assistance and checked through several drafts to ensure accuracy and consistency of style in the various papers. Thanks are due to all of them. I am also thankful to Dr. Susanne Thackray for her competent language editing of the volumes. Thanks are also due to Dr. Manazir Ahsan, Director General, Islamic Foundation, UK, and his colleagues who prepared the volumes for the press and ensured that they meet professional standards.

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Glossary of Arabic Terms

'Adl	Justice, fairness, balance.
Aḥādīth	(Plural of *ḥadīth*). For meaning, see *ḥadīth*.
Aḥkām	(Plural of *ḥukm*). For meaning, see *ḥukm*.
'Āqilah	That group of people who are liable to mutually share the blood-money liability of anyone among them.
'Aql	Reason.
Arkān	(singular *rukn*). Pillars. Necessary features of something.
Awqāf	Plural of *waqf*. For meaning, see *waqf*.
Āyah	A verse of Al-Qur'ān.
Bayt al-māl	Public treasury, also used for a charitable institution meant to help the poor and needy.
Bay'	Stands for sale. It is often used as a prefix in referring to different sales-based modes of Islamic finance, like *Bay' mu'ajjal*, and *Bay' al-salam*.
Bay' al-dayn	Sale of debt. According to a large majority of *fuqahā'*, debt cannot be sold except at its face value.
Bay' al-salaf	An alternative term for *bay' al-salam*.
Bay' al-salam	A sale in which payment is made in advance by the buyer and the delivery of the goods is deferred by the seller.
Bay' mu'ajjal	Sale on credit, i.e. a sale in which goods are delivered immediately but payment is deferred.

Bay' al-muḍāf	A sales contract in which delivery of both the commodity and the payment is deferred, e.g. forward sales in modern times. Such contracts are not permitted by the Sharī'ah.
Bay' bi thaman al-ājil	Another term used for *bay' mu'ajjal*.
Ḍamān	Guarantee, security, collateral.
Falāḥ	Literally, it means prosperity and success. Technically, it means achieving success in this life and in the life Hereafter.
Farḍ	An obligatory duty.
Fatāwā	(Plural of *fatwā*). Religious verdicts by *fuqahā'*.
Fiqh	Refers to the whole corpus of Islamic jurisprudence. In contrast with conventional law, *fiqh* covers all aspects of life, religious, political, social, commercial and economic. The whole corpus of *fiqh* is based primarily on interpretations of the Qur'ān and the *Sunnah* and secondarily on *ijmā'* (consensus) and *ijtihād* (individual judgement). While the Qur'ān and the *Sunnah* are immutable, *fiqhī* verdicts may change due to changing circumstances.
Fuqahā'	(Plural of *faqīh*), meaning jurist, who gives rulings on various juristic issues in the light of the Qur'ān and the *Sunnah*.
Ghabn Fāḥish	Over-pricing. Charging an unfairly high price, or taking an exorbitant rate of profit.
Gharar	Literally, it means deception, danger, risk and uncertainty. Technically, it means exposing oneself to excessive risk and danger in a business transaction as a result of uncertainty about the price, the quality and the quantity of the counter-value, the date of delivery, the ability of either the buyer or the seller to fulfil his commitment, or ambiguity in the terms of the deal; thereby, exposing either of the two parties to unnecessary risks.
Gharar Yasīr	A small amount of *gharar*. This is tolerable because it may be unavoidable.

Ghishsh	Literally, it means deception, fraud. Technically, it means trying to deceive someone by concealing vital information in a deal.
Ḥabs	An alternative term used for *waqf*. For meaning, see *waqf*.
Ḥadīth	Sayings, deeds and endorsements of the Prophet Muḥammad (peace be upon him) narrated by his Companions.
Ḥalāl	Things or activities permitted by the Sharīʿah.
Ḥaqq	Right.
Ḥarām	Things or activities prohibited by the Sharīʿah.
Ḥawālah	Literally, it means transfer. Technically, it refers to an arrangement whereby a debtor transfers the responsibility of payment of a debt to a third party who owes the former a debt. It is also used for cheque or draft.
Hibah	Gift.
Ḥikmah	Wisdom.
Ḥisbah	Literally, it means reward, calculation. Technically, it refers to an institution that existed through most of Islamic history for implementing what is proper and preventing what is improper. The main role of *al-ḥisbah* was the regulation and supervision of markets to ensure proper market conduct by all concerned.
Ḥukm	Sharīʿah ruling having general applicability.
ʿIbādāt	(Plural of *ʿIbādah*). Duties of man due to God.
Ibāḥah	Permissibility from a Sharīʿah point of view.
Iḥsān	Benevolence, kindness, virtue.
Iḥtikār	Hoarding (with a view to creating artificial scarcity for the purposes of charging a higher price).
Ijārah	Leasing. Sale of usufruct of an asset. The lessor retains the ownership of the asset with all the rights and the responsibilities that go with ownership.
Ijmāʿ	A consensus (of *fuqahāʾ*). *Ijmāʿ* is one of the sources of Islamic law.

Ijtihād	In technical terms, it refers to the endeavour of a jurist to derive a rule or reach a judgement based on evidence found in the Islamic sources of law, predominantly, the Qur'ān and the *Sunnah*.
'Illah	Reason/characteristic behind a Sharī'ah ruling such that if a particular reason/characteristic is found in other instances, the same ruling will apply.
Infāq	Spending. In the literature of Islamic economics, it usually refers to spending in the way of Allah.
Irfāq	An act of benevolence/charity for seeking the pleasure of Allah.
Istiḥsān	It refers to departure from a ruling in a particular situation in favour of another ruling, which brings about ease. This is done by taking a lenient view of an act which would be considered a 'violation' on a stricter interpretation of the action based on earlier *qiyās*.
Istiṣlāḥ	An unprecedented judgement within the overall Sharī'ah framework though not having explicit support from the Qur'ān or the *Sunnah*. Motivated by broader public interest, *istiṣlāḥ* is accepted as a source of Islamic law.
Istiṣnā'	Refers to a contract whereby a manufacturer (contractor) agrees to produce (build) and deliver a well-described good (or premise) at a given price on a given date in the future. As against *salam*, in *istiṣnā'* the price need not be paid in advance. It may be paid in instalments in step with the preferences of the parties or partly at the front end and the balance later on as agreed.
Ithm	A sinful act.
Jahl (also *Jahālah*)	Ignorance, lack of knowledge. In contracts, it refers to lack of information with respect to the subject of the contract or the terms and conditions of the contract.
Ju'ālah	A contract for performing a given task against a prescribed fee in a given period.
Kafālah	A contract whereby a person accepts to guarantee or take responsibility for a liability or duty of another person.

Kafīl	Guarantor.
al-Khilāfah al-Rāshidah	The period of the first four Caliphs after the Prophet Muḥammad (peace be upon him), ranging from the year 11 AH (632 AC) to the year 41AH (661 AC).
Khiyānah	Breach of faith, cheating, deception.
Khiyār	Option.
Khiyār al-ʿayb	Option to rescind a sales contract if a defect is discovered in the object of sale.
Khiyār al-ru'yah	Option to rescind a sales contract after physical inspection of the object of sale.
Khiyār al-sharṭ	The option to rescind a sales contract based on some conditions. One of the parties to a sales contract may stipulate certain conditions, which if not met, would grant a right to the stipulating party an option to rescind the contract.
Mafsadah	(Plural *mafāsid*). Anything declared harmful by the Sharīʿah or anything hampering the achievement of the *maqāṣid al-Sharīʿah*.
Maysir	Literally, it refers to an ancient Arabian game of chance with arrows used for stakes of live stock (e.g. Camels). Technically, gambling or any game of chance.
Māl	Asset, property, wealth.
Manīḥah	Granting permission to use the usufruct of an asset for a certain period of time without any charge.
Maqāṣid al-Sharīʿah	Basic objectives of the Sharīʿah. These are protection of faith, life, progeny, property and reason.
Maṣāliḥ mursalah	Public interest as determined in the light of the rules of Sharīʿah.
Maṣlaḥah	(Plural of *maṣāliḥ*). Literally, it means benefit. Technically, it refers to any action taken to protect any one of the five basic objectives of the Sharīʿah, i.e. protection of faith, life, progeny, property and reason.

Milkiyyah	Ownership.
Mu'āmalāt	Relationships/contracts/transactions among human beings as against *'ibādāt* which define the relationship between God and His creatures.
Muḍārabah	A contract between two parties, capital owner(s) or financiers (called *rabb al-māl*) and an investment manager (called *muḍārib*). Profit is distributed between the two parties in accordance with the ratio upon which they agree at the time of the contract. Financial loss is borne only by the financier(s). The entrepreneur's loss lies in not getting any reward for his services.
Muḍārib	An investment manager in a *muḍārabah* contract.
Mujtahid	A religious scholar qualified to give Sharī'ah rulings.
Murābaḥah	Sale at a specified profit margin. The term, however, is now used to refer to a sale agreement whereby the seller purchases the goods desired by the buyer and sells them at an agreed marked-up price, the payment being settled within an agreed time frame, either in instalments or in a lump sum. The seller bears the risk for the goods until they have been delivered to the buyer. *Murābaḥah* is also referred to as *bay' mu'ajjal*.
Musāqah	A contract in which the owner of a garden agrees to share its produce with someone in an agreed proportion in return for the latter's services in irrigating and looking after the garden.
Mushārakah	Partnership. A *mushārakah* contract is similar to a *muḍārabah* contract, the difference being that in the former both the partners participate in the management and the provision of capital, and share in the profit and loss. Profits are distributed between the partners in accordance with the ratios initially set, whereas loss is distributed in proportion to each one's share in the capital.
Mushārakah al-'aqd	Partnership resulting from a contract.

Mushārakah al-milk	Partnership in ownership of an asset arising from any event/action, for example from inheritance or gift.
Mustaḥiqqīn	Plural of *Mustaḥiq*. Those eligible (for help).
Mutawallī	Care-taker of a *waqf* property.
Muzāraʿah	A contract whereby one party agrees to till the land owned by the other party in consideration for an agreed share in the produce of the land.
Najas	Impure.
Najash	In reference to sales contract, it means contriving with the seller and bidding a higher price not with an intention to buy but simply to fetch a higher price from other potential buyers.
Niṣāb	In reference to *zakāh*, the limit of wealth that marks the beginning of the imposition of *zakāh* liability. Wealth below this limit is exempt.
Qāḍī	Judge.
Qarḍ or Qarḍ ḥasan	A loan extended without interest or any other compensation from the borrower. The lender expects a reward only from God.
Qimār	Gambling.
Qiyās	Derivation and application of a rule/law on the analogy of another rule/law if the basis (*ʿillah*) of the two is the same. It is one of the secondary sources of Islamic law.
Qiyās maʿ al-fāriq	*Qiyās* (analogy) based on dissimilar events. This is not an acceptable way of making *qiyās*.
Qur'ān	The Holy Book of Muslims, consisting of the revelations made by God to the Prophet Muḥammad (peace be upon him). The Qur'ān lays down the fundamentals of the Islamic faith, including beliefs and all aspects of the Islamic way of life.
Qurūḍ ḥasanah	(Plural of *qarḍ ḥasan*).
Rabb al-māl	Capital owner (financier) in a *muḍārabah* contract.

Ribā	Literally, it means increase or addition or growth. Technically, it refers to the 'premium' that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or an extension in its maturity. Interest as commonly known today is regarded by a predominant majority of *fuqahā'* to be equivalent to *ribā*.
Ribā al-faḍl	*Ribā* pertaining to trade contracts. It refers to exchange of different quantities (but different qualities) of the same commodity. Such exchange in particular commodities defined in Sharī'ah is not allowed. Different schools of *fiqh* apply this prohibition to different commodities.
Ribā al-nasa'	*Ribā* pertaining to loan contracts.
Ṣadaqah Jārīyah	An act of charity with perennial benefits.
Sadd al-dharā'i'	Prohibition of a deed which if permitted may lead to another prohibited deed.
Salaf	The short form of *bay' al-salaf*.
Salam	The short form of *bay' al-salam*.
Sharī'ah	Refers to the corpus of Islamic law based on Divine guidance as given by the Qur'ān and the *Sunnah* and embodies all aspects of the Islamic faith, including beliefs and practices.
Shirākah	Partnership. Technically, it is equivalent to *mushārakah*.
Sunnah	The *Sunnah* is the second most important source of the Islamic faith after the Qur'ān and refers to the Prophet's (peace be upon him) example as indicated by his practice of the faith. The only way to know the *Sunnah* is through the collection of *aḥādīth*, which consist of reports about the sayings, deeds and endorsements of the Prophet (peace be upon him).
Sūrah	A chapter of Al-Qur'ān.
Tabarru'āt	(Plural of *Tabarru'*.) Donations/gifts the purpose of which is not commercial but is seeking the pleasure of Allah.

Takāful	An alternative for the contemporary insurance contract. A group of persons agree to share certain risk (for example, damage by fire) by collecting a specified sum from each. In case of loss to anyone of the group, the loss is met from the collected funds.
Tawakkul	Trust in God for results after one has undertaken all necessary effort. It is one of the important values for Muslims. After making all necessary efforts, a Muslim believes that the results are in the hands of God.
Tawḥīd	Belief in the unity of God both in terms of person as well as in His attributes.
'Ulamā'	Scholars, plural of *'ālim*.
Ummah	The nation of Muslims.
'Urf	Established usage, custom. *'Urf* is one of the sources of Islamic law as long as it does not contradict the basic sources, i.e. the Qur'ān and the *Sunnah*.
'Ushr	Referring to the law of *zakāh*, it means a rate of ten percent leviable on certain types of wealth/output/income.
Wadī'ah	A contract whereby a person leaves valuables with someone for safekeeping. The keeper can charge a fee, even though in Islamic culture it is encouraged to provide this service free of charge or to recover only the costs of safekeeping without any profit.
Wakālah	Contract of agency. In this contract, one person appoints someone else to perform a certain task on his behalf, usually against a fixed fee.
Waqf	Appropriation or tying up a property in perpetuity for specific purposes. No property rights can be exercised over the corpus. Only the usufruct is applied towards the objectives (usually charitable) of the *waqf*.
Zakāh	The amount payable by a Muslim on his net worth as a part of his religious obligations, mainly for the benefit of the poor and the needy.

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CHAPTER 1

INTRODUCTION

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Poverty is one of the oldest enemies of mankind. On the one hand, the struggle between the 'haves' and 'have-nots' has led to the decline of many empires and civilizations and on the other hand, caring for the poor has invariably resulted in peace, progress and prosperity. These historical lessons have led to a universal recognition that alleviation of poverty should remain a high priority among the economic goals of mankind. However, approaches towards achieving this goal have differed and despite decades of debate and evaluation of actual experiences, there is still considerable controversy concerning suitable strategies and policies for poverty alleviation.

1. UNDERSTANDING THE DYNAMICS OF POVERTY

Poverty is a dynamic reality. Many factors interact to produce a certain level of poverty. Economic growth has been and still remains the most important factor in these dynamics. However, the

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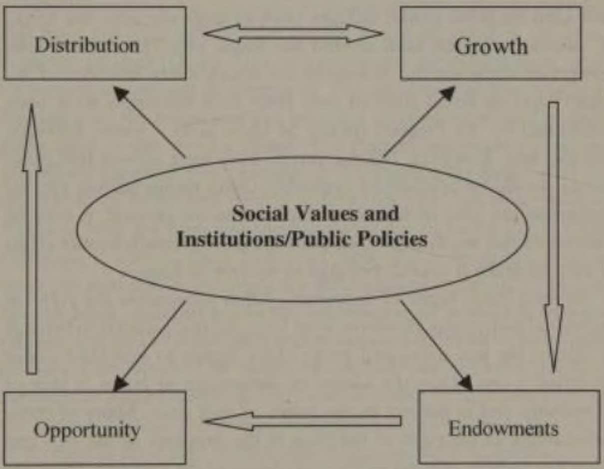
development experiences over the last fifty years show that while economic growth is a necessary condition for poverty reduction in general, this alone is by no means sufficient. The persistence of poverty in the midst of plenty has always generated a debate among economists with respect to the causality and interaction between growth and inequality. Many have argued that patterns of growth during the last fifty years in most countries have not substantially benefited the poor. Many even claim that the current pattern of growth actually widens income disparities between the rich and the poor, increasing poverty in many developing countries. The conclusion reached by Fransisco Ferreira (1999), who provides a useful overview of this debate, is quite instructive:

> "Income and wealth distributions can no longer be seen as mere outcomes of the general equilibrium of an economy. The central processes that determine resource allocation – through capital markets, through the political system, and through social circumstances – are influenced by the distribution of wealth in important ways. More unequal societies tend to develop larger groups of people who are excluded from opportunities others enjoy – be they better education, access to loans, or to insurance – and who, therefore, do not develop their full productive potentials. Both theory and empirical evidence suggest that these incomplete realizations of economic potential are not of concern only to those who care about equity *per se*. They also affect aggregate economic potential, and, therefore, aggregate output and its rate of growth. The inverted-U relationship between growth and inequality suggested by Kuznets has not survived recent empirical scrutiny terribly well. Instead, it is gradually being replaced by a perception that the main flow of causation may be in the other direction, with inequality hampering the rate and quality of economic growth. The debate is not over, either conceptually or empirically. But its very liveliness attests to the importance of the question. To paraphrase Tony Atkinson, inequality is unlikely to go back out into the cold periphery of economic analysis any time in the foreseeable future." (p.13)

Economic endowments – physical and financial resources available to a society – also crucially affect economic growth. Similarly, the opportunities such as jobs, credit, and infrastructure made available to different people; and the extent of human capital formation are important in determining the rate of growth that a society may achieve.

It must also be remembered that the development game is not played in space. Socio-political values, institutions and public policies are central to the process of growth and development. The dynamics of growth may thus be summarised as shown in Figure 1.1.

Figure 1.1: Dynamics of Growth



As will be seen later, the four elements shown here have important implications for poverty alleviation. It will, therefore, be useful to present the Islamic position about them.

1.1 Endowments

Ownership of factors of production is naturally the most important element in generating income and wealth. Islam has its own unique concept of ownership. Islam gives a number of instructions that have a bearing on ownership of factors of production. To begin with, there are certain types of resources that have been excluded from the scope of private ownership and have been reserved for the society at large. Broadly speaking, two kinds of productive assets have been reserved for such ownership. The first kind includes public utilities such as large streams, the banks of streams, and the land around the town, etc. The second kind comprises some natural resources for which every member of the society has an equal right of use. Four such resources have been mentioned by the Prophet (peace be upon him) – water, herbage, fire and salt. However, Islamic jurists have long argued that these things should be considered symbolic. Other things having similar properties are also included by implication. In general, it may be concluded that anything, which does not involve much human effort or cost to make it useful, belongs to society at large.

Beyond these types of resources, Islam recognises the right of individual ownership. However, even here, the real ownership belongs to Allah. He has delegated proprietary rights to mankind under specified terms. Thus the nature of ownership in Islam is that of trusteeship and is subject to the terms of that trust. Many of these terms relate to the right of the poor in the property of the rich and since this right is granted by the real Owner of the property, these are *claims* rather than voluntary contributions.

1.2 Opportunity

Many Islamic values and norms facilitate provision of opportunity to all, especially to the less advantaged sections of society. Islamic values emphasise that everybody should receive an equal treatment irrespective of his race, colour or gender. In the secular framework, a lot has been written about the rights of women, especially with respect to access to jobs. However, it should be noted that it was Islam that granted women the right to own property, share in inheritance and opportunities to run businesses 14 centuries ago. If appropriate norms of Islamic decency are observed, there is no bar on women to enter the job market and if they do, they are assured of equal treatment. It may be mentioned here that even today the contribution of women to economic development of a country is not fully recognised in the secular framework. For example, as an accounting practice, anything that does not pass through the market is not included in the gross domestic product (GDP). This underestimates the contribution made by women to national development. The services that they render in looking after the household and bringing up children should be fully recognised in the service sector. The present accounting practices are purely illogical. For example, if William's wife looks after the household of Peter and Peter's wife looks after the household of William, both get paid and their incomes are included in the GDP. However, if both of them look after their own households, none of them get paid and accordingly are not included in the GDP. This on the one hand, underestimates the contribution of women to national product and on the other, puts undue pressure on them to participate in market activities. The issues of unequal pay between genders, harassment and exploitation are a natural result of such practices. In the Islamic system, the proper recognition given to the contribution of women in their own households eliminates such problems.

Another important Islamic principle having implications for the provision of opportunities is the elimination of interest. Many scholars

have pointed out that distribution of credit in the society on the basis of interest is one of the major reasons of mal-distribution of income and wealth.[1] By prohibiting interest the Islamic system removes these disparities. It also provides greater opportunities for poor people to have access to credit.

1.3 Distribution

Islam is an egalitarian religion. Taking care of the poor and needy is so much emphasised in the Qur'ān and sayings of the Prophet (peace be upon him) that some scholars have gone to the extent of stating that anything which is beyond the needs of someone, should be spent in charity. While the majority of scholars do not subscribe to this extreme view, there is no difference of opinion among Islamic scholars that spending in charity is an essential trait of a true Muslim. The Qur'ān itself declares:

لــن تنالوا البر حتى تنفقوا مما تحبون وما تنفقوا من شيء فــإن الله به
عليم (آل عمران ٩٢)

> "*By no means shall ye attain righteousness unless ye give (freely) of that which ye love (wealth); and whatever ye give Allah knoweth it well.*" [3:92]

Islamic goals in the area of distribution can be summarised in the following three points:[2]

1. Guarantee of fulfilment of basic needs of all.
2. Equity but not equality in personal incomes, and
3. Eliminating extreme inequalities in personal income and wealth.

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[1] See for example, Chapra (1985), pp.109-110; and (1992), pp.328-9).
[2] Iqbal, Munawar (1986), pp.16-17.

There is complete agreement among Islamic economists that fulfilment of basic needs of all humans is the foremost objective of the Islamic distributive scheme. However, this does not mean that a basket-full of life's necessities would be doled out to every individual by the state in all circumstances. Individuals are normally expected to fulfil their needs through their own efforts. If due to some reasons it is not possible, then the responsibility to fulfil one's needs rests with one's near relatives, the neighbourhood and the society in general. The state, as an agent of society, is required to ensure that this has been done some way or another. As a last resort, *bayt al-māl* is responsible.

Having ensured the fulfilment of the basic needs of all, Islam permits differences in personal incomes. This derives from the Islamic view of justice to all. Individuals are different in terms of their talents and capacities. It would not be just to equate all people in terms of their earnings while they contribute differently to the production process. It is also inefficient. It would kill individual incentive and would be detrimental to productive efficiency.

Once it is understood that distributional justice does not mean, rather rules out, perfect equalities of income, one faces the question of the optimal level of inequalities. Here, Islam does not prescribe any ratio between the minimum and maximum incomes but discourages extreme inequalities. The purpose of the Islamic system is not only to establish justice but also to promote mutual love and kindness. Glaring disparities in income and wealth lead to social and political disruptions. Therefore, those inequalities, which cause hatred, malice, and ill feeling among individuals, need to be eliminated.

1.4 Growth

Islam gives due importance to growth and economic development. It stands for effort, hard work, efficiency and dynamism. There are numerous textual references in the Qur'ān and the *Sunnah* that all

resources in this universe have been created for the use of mankind. For example:

وسخر لكم ما في السماوات وما في الأرض جميعا منه إن في ذلك لآيات لقوم يتفكرون (الجاثية ١٣)

"And He has subjected to you (put in your service), as from Him, all that is in the heavens and on earth: behold, in that are indeed signs for those who reflect." [45:13]

Islam encourages its followers to do whatever is needed to exploit these resources for the service of society. It reminds its followers that while achieving welfare in the life Hereafter should remain the ultimate objective of human effort, this by no means implies monasticism.

ورهبانية ابتدعوها ما كتبناها عليهم إلا ابتغاء رضوان الله فما رعوها حق رعايتها (الحديد ٢٧)

"The monasticism, they invented for themselves. We did not prescribe (it) for them: (We commanded) only seeking the pleasure of Allah (in all deeds); but that they did not foster as they should have done." [57:27]

Islam also encourages its followers to perform their activities in the most efficient manner. The Prophet (peace be upon him) advised:

إن الله يحب إذا عمل أحدكم عملا أن يتقنه (كنز العمال، الجزء الثالث، رقم الحديث ٩١٢٨)

"Allah loves that whenever anyone of you performs a task, that he perfects it." [*Kanz al-ʿUmmâl*, Vol. 3: *Ḥadîth* No. 9128]

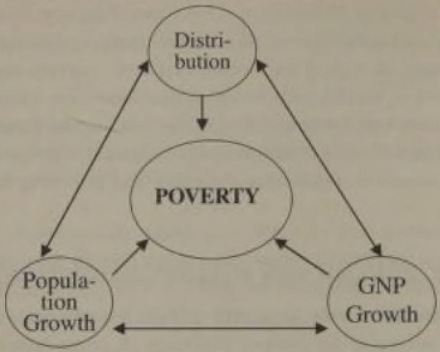
In view of these instructions, there is consensus among Islamic economists that economic growth and development is an important economic objective to be pursued with due diligence. However, in the Islamic system the focus of development efforts is man.[3] Development is a goal and value-oriented activity devoted to optimisation of human well-being. Islam deals with all aspects of economic development but always in the framework of total human development and never in a form divorced from this perspective. The emphasis, therefore, shifts from the quantity of growth to the quality of growth.

2. DYNAMICS OF POVERTY REDUCTION

As mentioned before, economic growth is a necessary but not a sufficient condition for poverty reduction. A given rate of growth in two countries may have entirely different impacts on poverty reduction. This is due, on the one hand, to the pattern and quality of growth and on the other hand, to population growth and demographic changes accompanying it. Population growth leads to increase in one of the most important factors of production, i.e., labour, but if that resource is not properly developed and employed, it can be a severe drag on the growth potential. In terms of poverty reduction it can eat away the advantages generated by growth. A simple framework for poverty reduction can thus be represented as follows:

[3] Ahmad, Khurshid (1980), pp.178-9.

Figure 1.2: Dynamics of Poverty Reduction



3. STRATEGIES FOR POVERTY REDUCTION

In the 1950s and 1960s, growth in the GDP was considered to be the best strategy for reducing poverty. It was argued that as the overall size of the 'cake' increases, its portions reaching different strata of the population would also increase. After two decades of GDPism, it was realised that this 'trickle down' scenario as an automatic mechanism for poverty alleviation does not work as desired. As a result, in the 1970s attention shifted to direct provision of nutritional, health and educational needs of the poor as a matter of public policy. It was also argued that improvements in health, education, and nutrition of the poor were important not only in their own right but also to promote growth in incomes including the incomes of the poor. Following this policy prescription, many countries instituted social welfare policies in the public sector for the provision of these needs. However, it was soon realised that this strategy is not sustainable in

the long run as it puts a heavy burden on government budgets. Countries in Latin America and Sub-Saharan Africa started tightening public spending in the 1980s. In the 1990s many other countries, including some developed countries, also started questioning the sustainability of this strategy. Many people began to doubt the effectiveness of public policy and especially policy towards the poor.[4] A shift in emphasis followed. It was argued that while provision of primary health care, nutrition and primary education to the poor is important, this alone is not sufficient. Switching to an efficient labour-intensive pattern of development and investing more in human capital formation are equally important, if not more so.

The development experience of the 1990s showed that both of these elements had several catches. Promoting labour-intensive growth is not easy, especially in the short and medium term. Provision of basic services to the poor which require more public spending brought to the forefront the trade-off between the interests of the poor and those of the non-poor. Mismanagement of public funds and corruption also became serious issues in this debate. It was increasingly realised that the participation of poor people in decision-making on the one hand and better governance of public funds on the other are of crucial importance. It was also realised that since the road to development has many bumps and shocks, both economic and natural, and since poor people are more vulnerable to these shocks, policies should be put in place to protect poor people from such shocks. Building on these elements, the *World Development Report* 2000/2001 proposed a strategy for attacking poverty in three ways: promoting opportunities, facilitating empowerment and enhancing securities.[5]

Provision of material opportunities such as jobs, credits, and infrastructure is the most important element in this strategy for poverty reduction. While it is recognised that overall economic growth

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[4] *World Development Report* 1990, p.2.

[5] *World Development Report* 2000/2001, pp.6-7.

is crucial for generating opportunities, the pattern and quality of growth is also important. Market reforms can be central in expanding opportunities for poor people, but the reforms need to reflect local institutional and structural conditions. Greater equity in the distribution of income can also play an important role in creating opportunities. Access to market opportunities and to public sector services is often strongly influenced by state and social institutions. Therefore, these institutions must be responsive and accountable to poor people. Sound and responsive institutions are not only important to benefit the poor but are also fundamental to the overall growth process. Reducing vulnerability to economic shocks, natural disasters, ill health and disability is also an intrinsic part of enhancing well-being. This requires effective national action to manage the risks and to protect poor people from these risks. It also requires building assets of poor people, diversifying household activities, and providing a range of insurance mechanisms to cope with adverse shocks.

4. ISLAMIC APPROACH TOWARDS POVERTY ALLEVIATION

The global strategies for poverty alleviation as developed over the last 50 years have a number of useful elements. Most of these are well recognised in Islam. Yet the Islamic approach towards poverty alleviation is quite distinct. Salient features of this approach are discussed below.

The strategies for poverty alleviation mentioned above inevitably involve two trade-offs: (i) between interests of the 'haves' and 'have-nots' and (ii) between the role of public sector versus the market. In both of these areas, the Islamic approach has some distinct features.

To begin with, Islam teaches us that the life in this world is a test. This life will be followed by an eternal life in which reward or punishment will depend on how one fares in this test. It then goes on to advise us that differences in income and wealth are part of this

test for both rich and poor and prescribes codes of behaviour for both. On the one hand, it advises the poor not to bear a grudge against those who have been given more and on the other hand, it encourages the rich to share their wealth with the poor freely. It advises all able-bodied persons to work hard to earn a living and treats such work as worshipping God. At the same time, it makes it obligatory for the society to fulfil the basic needs of all those who are unable to earn these for reasons beyond their control. It assures the poor that they will be richly rewarded in the life Hereafter for bearing their hardships patiently and at the same time assures those who come forward to relieve such hardships of an equally rich reward. In this way, Islam works on both ends of the equation to reduce poverty and promote social cohesion at the same time. It minimises the negative effects on individual incentives that ordinarily accompany redistribution schemes. The giver derives positive utility and enjoys rather than resents sharing his income and wealth with others. It also minimises the negative effects on work effort that ordinarily accompany unemployment and disability benefits and helps eliminate parasitic tendencies.

Islam also establishes a balance between the role of the public sector and the market. It utilises an 'institutional approach' in order to achieve its distributive goals. The market, as an institution, is allowed to play a significant role. It is however, supplemented by many other institutional arrangements to correct some in-built tendencies in the market solutions. These institutions include *zakāh*, elimination of interest, Islamic rules of ownership of wealth and natural resources, Islamic law of inheritance, compulsory maintenance of certain relatives, etc. The important feature of these institutional arrangements is that they are Divinely-ordained and are not subject to political or social manipulation. There are many other built-in institutions such as *awqāf*, *takāful*, *irfāq*, etc., which are backed by Sharī'ah rules and regulations. While these institutions do allow *ijtihād*, they are also not subject to 'popular' or so-called democratic practices.

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In terms of the growth, distribution and population triangle (Figure 1.2), writers in Islamic economics have placed most of the emphasis in their poverty-reduction agenda on distribution. The roles played by economic development and growth in population in poverty alleviation have not received the attention that they deserve. In our view, these elements of the dynamics of poverty reduction are equally important. We have mentioned above that Islamic values place a lot of emphasis on exploiting the resources of the universe for the benefit of society, on working hard and on promoting efficiency. We have also mentioned that Islam does not endorse monasticism. It encourages its followers to acquire a decent living standard and a life of ease and comfort.

قــل مــن حرم زينة الله التي أخرج لعــباده والطيبات من الرزق (الأعراف ٣٢)

"Say: Who hath forbidden the beautiful (gifts) of Allah, which He hath produced for His servants, and the things, clean and pure, (which He hath provided) for sustenance?" [7:32]

يريد الله بكم اليسر ولا يريد بكم العسر (البقرة ١٨٥)

"Allah intends every facility for you; He does not want to put you to difficulties." [2:185]

Islam also enjoins its followers to gain power and strength for the *ummah*. In the modern world economic power is the clearest manifestation of the strength of a nation. Therefore, economic growth is important not only for poverty reduction, it is desirable in its own right.

The enormous role that economic growth plays in poverty reduction is an empirical reality. *World Development Report* 2000/2001, after analysing the evolution of poverty across countries in the

last two decades, concludes that differences in economic growth across countries account for much of the variation in poverty experiences. On average, growth in the consumption of the poorest fifth of the population tracked economic growth one-for-one. In the vast majority of cases growth led to rising consumption in the poorest fifth of the population, while economic decline led to falling consumption.[6] Similarly, the pattern of growth is also important. The one most important variable in these regards is the distribution of income. In a recent study, Ali and Elbadawi (1999) as quoted by Ismail Sirageldin in Chapter 2, examine the observed experience of selected developing countries in four regions: the Arab region including six Arab countries; Sub-Saharan Africa; Latin America; and Asia. For the six Arab countries, although the rate of economic growth was relatively high at 3.3%, poverty increased by 1.3% mainly as a result of the predicted high rate of growth in inequality, at 4.4%. For Sub-Saharan Africa, the predicted growth in poverty was positive, mainly as a result of worsening inequality. Economic growth had no effect in reducing poverty since its average was zero during the period. The experience of Latin America was similar to that of the African countries; low growth and worsening inequality that generated a high rate of growth in poverty. On the other hand, there was a significant decline in poverty in the Asian sample (China, India, Malaysia, Pakistan, Philippines, Sri Lanka). The increase in inequality was sizable but was more than compensated by a large growth effect that dominated the negative distributional effect.

In Islamic writings on poverty alleviation, the least attention has been given to the role of population growth and demographic changes. This is rather unfortunate. Muslim writers on the subject are swayed by the opinion held by a vast majority of Islamic scholars that adoption of family planning as a national policy is against Islamic teachings. They tend to forget that population policy is a lot more than family

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[6] Ibid., p.47.

planning. If properly managed, growth in population and other demographic changes can unleash powerful forces for growth. After all, labour is an important factor of production.

As an example, Sirageldin (Chapter 2) refers to the "demographic window of opportunity". He points out that almost all Islamic countries have entered a phase of demographic transition that presents enormous opportunities for development that have the potential to reduce poverty. This phase of demographic transition, associated with delayed but accelerated fertility decline can produce positive developmental consequences through its effect on the age structure, labour force participation, and geographical and occupational mobility. However, in order to exploit these opportunities, appropriate socioeconomic policies should be put in place quickly. The moral of this example is that population policies do not end with family planning. They involve developing young people into a productive work force through human capital formation, creating jobs for them, providing finance to make them successful businessmen and to provide a secure environment to enable them to flourish.

4.1 Institutional Approach for Poverty Reduction

The most important aspect of Islamic strategy for poverty reduction is its 'institutional approach'. There are a number of built-in 'institutions' in the Islamic system that play an important role in reducing poverty. These were mentioned in Section 4. Some of these have been taken up by the writers in this volume.

Hafiz Yasin and Sayyid Tahir (Chapter 3) examine the effects of introducing *zakāh* and eliminating interest from the economy using Pakistan as a case study. Employing a Computable General Equilibrium Model, they simulate important macroeconomic variables for a period of ten years over the base of 1989-90. Four policy alternatives are compared: maintaining the status quo; introducing *zakāh* only; replacing interest by profit-sharing and full-scale Islamisation that

admits *zakāh* and profit-sharing simultaneously. It is shown that full-scale Islamisation produces the best results for alleviating poverty and improving income distribution. Even the two alternatives of partial Islamisation are shown to be superior to the status quo though the gains are much smaller as compared to full-scale Islamisation.

Tag el Din (Chapter 5) argues that elimination of interest alone cannot perform its re-distributional function. It must be supported by an active *irfāq* (non-profit) sector, another Islamic institutional arrangement, which adds voluntary charity to compulsory payments of *zakāh*. He refers to the common distinction between *ribā al-nasa'* and *ribā al-faḍl* on the one hand and curative and preventive strategies for achieving re-distributive goals on the other hand. Curative strategy refers to non-market resource allocative measures to satisfy certain social wants. A non-utilitarian authority such as government raises scarce resources and re-allocates them for the production of non-marketable public goods. Preventive strategy involves two kinds of measures, market regulation and regulation of money supply. He then portrays the elimination of *ribā al-nasa'* as curative and elimination of *ribā al-faḍl* as a preventive measure under the category of market regulation. He goes on to show how the elimination of *ribā al-faḍl* is a market regulation strategy for prohibiting monopolistic practices. He advises that Islamisation schemes should treat monopolistic practices as a manifestation of *ribā* and seek to eliminate them. In the case of *ribā al-nasa'*, since this is a curative measure and since in the Islamic framework the non-utilitarian authority which addresses cases of market failure is the *irfāq* sector (as compared to public sector in the secular framework), the elimination of *ribā al-nasa'* in his view can yield the desired re-distributional results only when supported by an active *irfāq* sector.

One important institution in the *irfāq* sector is the *waqf* system. This is taken up by Çizakça (Chapter 7). A *waqf* is established when a privately owned property, *corpus*, is endowed for a charitable purpose in perpetuity and the usufruct generated by it is spent on the

specified purpose. Çizakça points out that many essential services such as health, education, municipal services, etc., were all provided in Islamic states at no cost whatsoever to the government. This was achieved not through the Western method of re-distributive taxation but through voluntary donations without any state coercion. Thus the *waqf* system emerged as the most important institution of poverty alleviation in the Islamic world. Quoting budget studies from the 16th century Ottoman Empire, he reveals that the entire government expenditure was limited to military spending. The *waqf* system thus helps in reducing government expenditure dramatically. That in turn, leads to a reduction in budget deficit thus lowering the need for government borrowing, curbs the crowding-out effect, and leads to a reduction in interest rates, thus removing a major impediment to private investment and growth. The *waqf* system also solves the problem of under-supply of public goods so often observed in conventional economies due to inadequate representation of the poor in the decision-making process.

It is useful to note here that disappointed by the dismal performance of the state sector in providing essential social services to the poor and shocked by the exorbitant cost of these services when provided by the state, a massive transformation is underway in Western countries with respect to poverty reduction policies. Learning from the experience of the *waqf* system, the West is rediscovering the virtues of the non-profit sector and NGO activity is growing at a rapid pace. The movement is making an impressive contribution in providing a number of social services. Islamic countries can, in their turn, learn a lot of lessons from these experiences. Çizakça especially draws our attention to the principle of subsidiarity used in Germany. This principle assigns priority to non-profit over the public provision of social services. This principle is very close to the Islamic concept of *waqf* foundation. Çizakça maintains that since it may be both unrealistic and undesirable to push back the state completely out of the provision of essential services, the German concept of subsidiarity,

which avoids duplication of effort and ensures a clear division of labour between the state and the non-profit sector, appears to be a useful idea to borrow. .

Kabir Hassan and Alamgir (Chapter 4) examine the role of NGOs in poverty alleviation in Bangladesh through provision of micro-finance to the poor segments of society. They highlight that provision of microcredit has improved the quality of life of millions of people in Bangladesh. Microcredit has also been found to be an effective instrument for creating self-employment. Several microfinancial institutions (MFIs) are providing collateral-free credit to the rural poor on the basis of group guarantee. They provide a comparative analysis of secular and Islamic NGOs in rural Bangladesh. While the secular MFIs have been operating since the 1980s, Islamic MFIs have started their operations quite recently. Secular MFIs charge high rates of interest of about 30% which is more than double the formal banking rate and pay only 5-6% interest to the members on their mandatory savings. The Islamic NGOs do not provide cash loans. They use the concept of *bay' mu'ajjal* with a mark-up of about 12% to provide small productive assets. Secular MFIs, which depend for their funds on Western donors, have a lot more funds at their disposal as compared to Islamic MFIs, which are starved of funds despite ample opportunities to expand and a huge demand for Islamic microfinancial services. In view of the huge potential for microcredit in poverty alleviation, Islamic countries are well advised to pay more attention to this area.

An important element in the modern poverty-reduction agenda is to protect people from shocks, both economic and natural, which can suddenly hurl them into the quagmire of poverty. In the Islamic system, there is an institution of *takāful* (mutual surety) which addresses this aspect. Basically, *takāful* is a cooperative proposition predicated on mutual support. Daud Bakar (Chapter 6) discusses this concept in some detail and relates it to the theory and practice of insurance in the modern world. He argues that since the *takāful* contract is meant to provide mutual help and assistance, *prima facie*

all types of risks are insurable from an Islamic point of view as long as the objective is to mutually indemnify one or more participants facing some risks rather than commercial gain. He uses this principle to evaluate various types of modern insurance contracts and concludes that the Islamic concept of *takāful*, would, on the one hand, permit insuring certain risks that conventional insurance shuns, namely speculative risks and would, on the other hand, prohibit certain types of life insurance contracts that conventional insurance permits. While one may not agree with all of his conclusions, he has certainly projected the institution of *takāful* as a powerful instrument of mutual support. That has important implications for poverty alleviation.

5. GLOBAL POVERTY TODAY

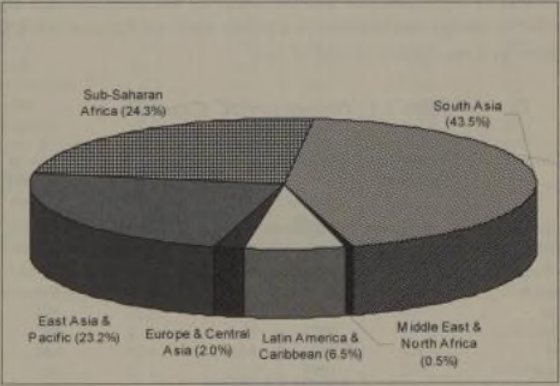
In order to comprehend the magnitude of the problem at hand, it would be useful to look at the current picture of poverty in the world. Over the last three decades, especially during the 1990s, substantial progress has been made toward reducing global poverty. Per capita private consumption growth in developing countries averaged about 1.4% a year between 1980 and 1990 and 2.4% between 1990 and 1999, helping millions of people cross the poverty line. The proportion of the developing world's population living in extreme economic poverty – defined as living on less than $1 per day in 1993 dollars, adjusted to account for difference in purchasing power parity – has fallen from 28% in 1987 to 24% in 1998. However, the absolute number of people in poverty has hardly changed because of the growth in population.[7]

While there has been substantial progress in alleviating poverty, it has been far from even, and the global picture masks large regional differences. East Asia and the Middle East and North Africa have reduced their numbers in poverty. But in all other regions the number

[7] Ibid., p.21.

of people living on less than $1 a day has risen. The decrease in the proportion of the population living below the poverty line has not been enough to reduce the total number of poor. In South Asia for example, the number of poor people increased between 1987 and 1988 from 474 million to 522 million, even though the share of people in poverty fell from 45% to 40%. In Latin America and the Caribbean the number of poor people rose by about 20%.[8] The global distribution of population living on less than $1 a day in 1998 as given in *World Development Report* 2000/2001 is reproduced below.

Figure 1.3: Distribution of Population Living on Less than $1 a Day (1998)



[8] Ibid., p.22.

It will be interesting at this point to look at the situation of Muslim countries. Table 1.1 presents some data on poverty in some members of the Organisation of Islamic Conference (OIC). The average percentage of population living below the poverty line in the 30 countries for which data has been reported works out at 27.7. As may be noted, the data mostly pertain to the mid 1990s. Interestingly, the average figure for people below the poverty line in the world in 1993 was also 27.7.[9] Therefore, it may be concluded that on average the level of poverty in Muslim countries is similar to other countries in the world. In that case, the number of people living below the poverty line in Muslim countries would be around 290 million today. That means that roughly one in every four individuals is living in absolute poverty. From the point of view of an Islamic system, which calls for the fulfilment of basic needs of everyone, this situation leaves a lot to be desired. It is high time that Islamic scholars and governments work together to design and implement a policy package that can solve this problem in a reasonable period of time.

Table 1.1: Poverty in OIC Countries

Country	Population (Millions)	Population Below the Poverty Line			Type of Poverty Line*
		Survey Year	%	Number (Millions)	
Algeria	28.5	1995	22.6	6.44	NPL
Azerbaijan	7.4	1995	68.1	5.04	NPL
Bangladesh	120.1	1996	35.6	42.76	NPL
Benin	5.3	1995	33.0	1.75	NPL
Burkina Faso	10.1	1994	61.2	6.18	IPL
Chad	6.5	1996	64.0	4.16	NPL
Cote d'Ivoire	14.2	1995	12.3	1.75	IPL
Egypt, Arab Rep.	60.6	1996	22.9	13.88	NPL
Guinea	7.3	1994	40.0	2.92	NPL

(continued on p.23)

[9] Ibid., Table 1.1, p. 23.

Table 1.1: Continued

Country	Population (Millions)	Population Below the Poverty Line			Type of Poverty Line*
		Survey Year	%	Number (Millions)	
Indonesia	205.0	1998	20.3	41.62	NPL
Jordan	4.3	1991	15.0	0.65	NPL
Kazakhstan	16.5	1996	34.6	5.71	NPL
Kyrgyz Republic	4.4	1993	40.0	1.76	NPL
Malaysia	18.2	1989	15.5	2.82	NPL
Mali	10.6	1994	72.8	7.72	IPL
Mauritania	1.9	1990	57.0	1.08	NPL
Morocco	25.2	1991	13.1	3.30	NPL
Mozambique	17.3	1996	37.9	6.56	IPL
Niger	8.1	1992	63.0	5.10	NPL
Nigeria	110.5	1993	34.1	37.68	NPL
Pakistan	112.8	1991	34.0	38.35	NPL
Senegal	8.4	1995	26.3	2.21	IPL
Sierra Leone	3.9	1989	68.0	2.65	NPL
Togo	3.4	1989	32.3	1.10	NPL
Tunisia	8.1	1990	14.1	1.14	NPL
Turkey	60.5	1994	2.4	1.45	IPL
Turkmenistan	4.2	1993	20.9	0.88	IPL
Uganda	18.1	1993	55.0	9.96	NPL
Uzbekistan	21.3	1993	3.3	0.70	IPL
Yemen, Rep.	12.7	1992	19.1	2.43	NPL
TOTAL	**935.4**		**27.7****	**259.7**	

* NPL refers to National Poverty Line from national surveys. Where NPL is not available, International Poverty Line (IPL) as reported in *World Development Report* 2000/2001 is given.

** Average of 30 countries.

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Chapter 2

The Elimination of Poverty: Challenges and Islamic Strategies

*Ismail Sirageldin**

1. INTRODUCTION

Poverty is a complex phenomenon. It has persisted in varied degrees in societies and communities around the world since recorded history, regardless of resource endowment, the stage of development, level of technology, social structure or culture. However, societal approaches to poverty alleviation have varied significantly from indifference to active intervention, from reliance on private or collective strategies, and between distribution and growth strategies, depending on the efficacy of existing socio-economic institutions and the prevailing social values. Throughout history, individual and social values, especially where equalitarian ideology ranks high, have been important determinants of how individuals and society view poverty as an issue that requires attention at society level. For Islam, as an ethical system, it is an accepted premise that policy decisions

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in an Islamic society must pass through an Islamic moral filter. The Islamic ethical system provides for more than a "Bill of Rights". Its system defines a "Bill of Rights and Obligations" that guides the behaviour of government and the governed. However, we agree with Khurshid Ahmad's recent assessment that the present status of Islamic countries is "still under the shadow of the Western system and, as such, it is doubtful how 'representative' of the Islamic ethos its current behaviour can be" [Ahmad (1994), p. xiv]. To examine the performance of Islamic countries and conclude whether they adhere to the ethical principles of Islam requires much more knowledge about the performance of these countries and how these performances adhere to Islamic ethical and legal systems, a task beyond the capacity of the present author.

Our approach in the present paper is to focus on Islam as a system of ethics, treating the Islamic ethos as an ideal through which socio-economic policies dealing with poverty reduction/prevention are assessed. We find the axiomatic approach, developed by Naqvi (1994) and applied in an earlier analysis of Islam, society and economic policy [Sirageldin (1996) pp. 224-227] to be helpful to the present discussion. The axiomatic approach is based on four basic tenents of the Islamic ethical system:

Unity (*tawḥīd*): this axiom indicates the vertical dimension of the ethical system. It provides for freedom of action whereby each individual is viewed as an integral part of the whole.

Equilibrium (*al-ʿadl wa'l-iḥsān*): this axiom provides for the horizontal dimension of equity leaving a lot of freedom for policy details, as, for example, striking an appropriate balance between the needs of present and future generations.

Free-will (*ikhtiyār*): although individual freedom is guided by broad guidelines, and individuals may travel their own paths, careful intellection is required "to interpret-reinterpret that freedom within specific societal contexts, and to suit the needs of changing times" [Naqvi (1994) p. 31].

Responsibility (*farḍ*): this axiom states that although 'responsibility' is voluntary, individuals and society need to conserve for the public good. Hence, there is a social aspect of every asset owned or managed by private or public entities.

These four axioms, taken together, lead to a universal ethical system that implies that policies should not lead to dependency, limit opportunities that develop capabilities for the few, or reduce individual responsibilities for taking action. Policies should enhance motivation to seek knowledge, enhance productivity, and enhance transparency in government. They should also enhance intra- and intergeneration equity.

In the present discussion, the system of Islamic axioms serves as an ethical 'filter' to assess policies, a challenging task. However, our purpose is not to develop Islamic solutions but rather review some current strategies and programmes of poverty alleviation/elimination and assess whether their objectives and intentions pass the Islamic ethical filter. Programmes and strategies are subject to the inevitable process of trial and error, a continuous learning process.

This paper is divided into three Sections. The first is descriptive. It examines briefly the concept of poverty, its spatial and temporal dimensions, and the challenges of its measurement and policy assessment over time. The second Section is conceptual. It focuses the discussion of poverty around a question that we feel essential to the understanding of its full dimensions, its causes and its remedial and preventive policies: are the poor, poor because they live in poor communities or unfavourable environments? Or are they poor because their parents were poor? The answer to this question goes beyond economic analyses into the socio-political structure of society: the distribution of income and assets including human capital and capabilities, the distribution of opportunities especially in a wage-earning capacity, the role of rent-seeking behaviour, and the lack of social, geographic and occupational mobility. In this context, the fundamental triangle of poverty, distribution and growth is elucidated.

In the third Section, we attempt to reduce the varied strategies dealing with poverty into a few basic dimensions: long-term policies

targeted to enhance the capabilities or increase the domain of opportunities while reducing barriers to mobility, and policies targeted for temporary remedial measures, although some of the latter could become institutionalised at least for those that may not be empowered, being handicapped or disabled. We also find it instructive to refer to the development paradigms and strategies of the 1960s when national and international interest in economic and social development took hold. The parallel is striking, especially in some of the negative externalities that influence human development. Our search leads to the conclusion that for policies to be effective a technical and empirical understanding of poverty is a necessity, but for that understanding to be effective, it must be combined with efficient institutions and a supportive system of social values. Invoking value judgements based on collective consensus seems essential for the choice and implementation of policies. Long-term commitment requires political consensus especially in a zero-sum game-type environment and where the implementation of policies leads to negative social externalities, for example, rent-seeking behaviour, free-rider-type behaviour, or the institutionalisation of poverty. The discussion leads to an exploration of the role of Islam as a system of ethical axioms in supporting policies designed to eliminate poverty while enhancing sustainable growth and equitable human development. The paper ends with some concluding remarks.

2. ON THE CONCEPT AND MEASUREMENT OF POVERTY

The development of effective policies for poverty reduction and the monitoring of their progress and efficacy may not be feasible without a clear definition of poverty that can be measured with consistency across space and time. However, there are known difficult problems with defining and measuring poverty. There is no optimal definition or a measurement technique to compare poverty across countries or even within a country. Three decades ago, Martin Rein

(1970, p.46) identified three broad concepts of poverty that seem to encompass most of the difficulties associated with poverty analysis: subsistence, inequality, and externality. Subsistence is concerned with the "minimum of provisions needed to maintain health and working capacity" (capabilities). Inequality is concerned with the "relative position of income groups to each other." Hence, the concept of poverty must be seen in the context of society as a whole. Poverty cannot be fully understood by isolating the poor and focusing on their behaviour as a special group. It is equally important to understand the behaviour of the rest of society especially the richer segment and that of the rich economies. Externality is concerned with the "social consequences of poverty for the rest of society rather than in terms of the needs of the poor – it is not so much the misery and plight of the poor but the discomfort and cost to the non-poor part of the community which is crucial to this view of poverty." This latter view provides the political and social dimensions of policies dealing with poverty. On the one hand, the poverty line serves as an index of the disutility to the community of the persistence of poverty. It reflects the extent of socio-political commitment [Smolensky (1970)]. On the other hand, it opens the door for the analysis of poverty as a social stratification problem, whether poverty is inherited across generations, or confined to geographic locations. The conceptualisation of poverty has advanced since then, especially its macroeconomic linkages with distribution and growth. Recent advances in this direction have been helpful in elucidating poverty-related policies and strategies [Ali and Elbadawi (1999), Squire (1999), and papers presented at the 1999 World Bank Stiglitz Summer Research Workshop on Poverty, and references cited therein]. However, understanding the socio-political environment and required institutional capacities at local, national, or international levels continues to raise challenges and unsettles the conceptual and measurement problems necessary for developing effective policies and strategies.

Each of the concepts outlined by Rein (1970) present numerous conceptual, definitional, and measurement problems. Some continue to be part of the active research on the subject as reflected, for example, in the cautionary end notes on the data quality, conceptual, and measurement difficulties with data published recently on national and international poverty lines [*World Development Report* (2000), p.65]. It is not evident, for example, whether "the international poverty line measures the same degree of need or deprivation across countries" (ibid). The same is true for comparing poverty measures within countries, for example, rural-urban comparisons. In an attempt to bring together four basic dimensions of human deprivation, the *Human Development Report* (1999), UNDP developed a multi-dimensional Human Poverty Index (HPI) based on health status, knowledge, economic provisioning, and social inclusion. Although maintaining the same conceptual dimensions, the indicators of the HPI vary between developing countries (HPI1) and industrialised countries (HPI2). For example, for the latter countries, income measure was used to indicate economic provisions while public provisioning was used for developing countries. The HPI provides useful cross-sectional and temporal international comparisons. For developing countries, the HPI1 reveals that, in 1997, human poverty ranged from a low of 2.6 percent in Barbados to a high of 65.5 percent in Niger. Thirty countries had a poverty index of at least 25 percent and 14 countries of at least 35 percent. The incidence of poverty is widespread and concentrated in Africa and South Asia. However, the HPI seems to suffer from the same problems mentioned above, of data quality and consistency. Furthermore, being a macro indicator, there is the difficulty of interpreting the findings for policy analysis or in the formulation of poverty-reduction strategies.

There have been recent advances in survey methodologies and econometric techniques that attempt to achieve a more complete account of household market and non-market income and consumption. The analyses of these surveys provide a clearer picture of the problem of poverty around the world although with varied

coverage and quality. For example, according to some authorities, current survey data and measures do not cover the full dimensions of poverty, required for the development of effective policies that deal with both 'chronic' and 'transient' poverty [Thorbecke (1999)]. It is not our intention to provide a detailed account of measurement issues; there is a wealth of these to be found elsewhere.

Our purpose is simply to indicate that poverty is a multi-dimensional concept. A quantitative money-metric consumption (or income)-based approach is not sufficient. It needs to be expanded to measure socio-political externalities, both a result of the presence of poverty and of the introduction of policies to alleviate it. The latter could be a source of significant negative externalities that are in direct conflict with the objectives and performance of policies and programmes, as well as with prevailing ethical systems including that of Islam, as discussed later. An in-depth understanding of the socio-political environment on the local and larger societal and international levels seems essential. There is a lot to be desired in the field of defining and measuring poverty. For example, while the design of better and consistent data should continue to be a priority, there is a need for a better balance and coordination between national and local level commitments to poverty alleviation, although the globalisation of labour markets present challenges to such coordination. The localisation of policies and raising the awareness of local communities, where data is more accessible and less costly and its use is more effective, about the full dimensions of poverty and its externalities should be part of the larger poverty-reduction strategies. Although care needs to be exercised about the optimal size and temporal limits of the distributional component of such approaches. The experience with successful community health strategies and programmes, especially those with cost recovery provisions and their synergies with successful macroeconomic policies could serve as an example. At present, care must be exercised in interpreting findings for policy analysis and evaluation.

3. ON THE EVOLUTION AND DYNAMICS OF POVERTY

The previous discussion indicates that poverty cannot be viewed in isolation of the socio-economic environment and the political system. Poverty-reduction strategies and policies are part of overall 'development' strategies. We focus, however, on the basic triangle of poverty, distribution, and growth and the synergies among them. Although economic forces are important, it is evident that socio-political, cultural, and other non-economic factors associated with 'human development' are embedded in these synergies and play pivotal roles in the policy analysis of poverty alleviation. An important factor in the present phase of development in Islamic countries, shared by most developing countries, is the stage of their demographic transition. It is instructive to start with these economic-demographic dynamics as a base for understanding the evolution and dynamics of poverty in these countries. There are three reasons for this focus. The first is that demographic change shapes the destiny of development prospects through their consequences, while being shaped by development processes and outcomes. The second is that demographic outcomes include externalities that have intra- and inter-generation distributional consequences that affect the size and intensity of poverty. The third is that the present stage of the demographic transition presents opportunities for development that have the potential to reduce poverty. These opportunities, however, are conditional on the presence of supporting socio-economic policies and political commitments. It must be emphasised that the present discussion is not normative in the sense of promoting a course of demographic policy action. It is based on established demographic trends in developing countries and an analysis of their consequences.

For all practical purposes, almost all Islamic countries have entered the final phase of the demographic transition. This phase of demographic transition, associated with delayed but accelerated fertility decline has the potential for positive developmental

consequences through its effects on the age structure, labour force participation, and geographic and occupational mobility. This development potential is labelled in the literature as the demographic window of opportunity. The policy focus in this stage should be on how to capitalise on the development potentials of the window of opportunities. Population growth is expected to decline in the coming decades, mainly as a consequence of the decline in fertility that maintained high levels for generations. Meanwhile, crude death rates are expected to rise, as the age structure gets older with the result that population growth declines even faster. An important consequence of these demographic dynamics is the change in the natural growth rates of the various age cohorts. Thus, although the overall rate of population growth is declining, the growth of the population in the working age is expected to grow at rates that are higher than that of the population as a whole, and especially higher than the growth rates of younger generations. The cohorts in the working age are expected to maintain these high rates of growth for at least a generation, while the older cohorts will gain significantly in relative size in the coming decades. As the populations reach their stationary state, their size will increase. However, the gain in size will be concentrated in the age cohorts above 30. In fact, the younger cohorts, less than 15 years old, will lose in absolute size. The consequences of these demographic patterns to population growth and age structures are well established and are certain to materialise. Apparent differences among countries are a result of differences in initial age structures and the timing of the onset of fertility decline. These are only a matter of timing that impact expected cohort sizes at the stationary state. They are not differences in the pattern of demographic change that is already taking place. However, these differences could generate inter-country differentials in labour-capital intensity that may generate pressure for labour and or capital migration while increasing inequality and the incidence of poverty.

In this transitional environment of high rates of growth of the population at the working age and the relative small size of the elderly

population, the burden of economic dependency declines and the potential for saving increases, thus providing a one-time demographic window of development opportunity. The idea of this window of opportunity is simple: with high rates of labour growth, the turnover in the aggregate supply of labour is faster in this stage of transition. Accordingly its quality, whether good or bad, could be changed at a fast rate. However, the positive opportunity is only a potential. It all depends on whether the potential for saving, generated by changes in the age structure, has been channelled into productive and equitable investment in human capital, enhancing labour demand, and the presence of appropriate social reform among others. This window of opportunity could be as negative as it could be positive. For example, the decline of fertility may not be separated from the low equilibrium trap, with no significant improvement in the quality of education. And as evident, the relative abundance of the labour component of this opportunity has been witnessed in many of the developing countries for some time including Islamic countries but has been squandered through limited human capital accumulation and the prevalence of unemployment and underemployment. The result is the emergence of poverty on a large scale.

One thing is certain in this transitional environment. The supply of labour will more than double in almost all Islamic countries in the next three decades. This built-in growth presents a double-edged challenge: how to produce, in the face of high rates of labour force growth, the quality of human resources that is internationally competitive and which can also be engaged productively in local and global labour markets? This prospect requires a sizable social investment in quality education, health and infrastructure. It also implies increased competition in the allocation of scarce resources. Who and how many will be left out in the distribution of acquired capabilities and of productive opportunities depends to a large extent on the development strategies adopted, especially their effectiveness and egalitarian content. Roemer (1999), for example, singles out equality of opportunity in wage-earning capacity as the most

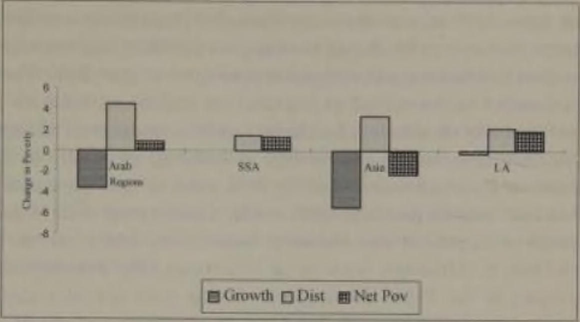
important strategy for poverty-reduction policies. As he defined it: "equalizing opportunities for wage-earning capacity across citizens in a society means using social policy (educational policy but other policies, as well) to *compensate* individuals for the disadvantage inherited in their circumstances" (ibid.: emphasis added). However, to implement such policies requires political will, favourable polities, long-term commitment and the presence of a supportive ethical system, some of which are in short supply.

Our brief review of the opportunities and constraints set by the demographic window of opportunity in Islamic countries indicates the *potential* for sustained growth that could lead to a sustained reduction in poverty, if the right policy environment prevails. The potential saving from a pure demographic structure could be channelled towards equitable human capital formation with an internationally competitive quality. Countries in East Asia including some Islamic countries, Malaysia and to a lesser degree Indonesia have been able to follow the path towards sustainable development and reduced poverty. There are trade-offs however, between growth, distribution and poverty as illustrated by recent economic modelling that include political factors in their specifications [cf. Rodrik (1998)]. Some provide enlightened policy recommendations. For example, in a recent study of poverty in the Arab world and the role of inequity and growth, Ali and Elbadawi (1999) used a simple dynamic model of poverty, growth, and distribution to explain the observed experience of selected developing countries located in four regions: the Arab region including six Arab countries, Sub-Saharan Africa (SSA), Asia and Latin America (LA). The model allows an investigation into which countries would require an acceleration of growth, redistributive measures, or both in order to achieve a sustained reduction in poverty. The findings reproduced in Figure 2.1 are illustrative of how poverty responds to changes in growth and distribution during the 1975-1996 period of analysis. For the six Arab countries, although the rate of economic growth was relatively high at 3.3 percent, poverty increased by 1.3 percent mainly as a result of the predicted high rate of growth

in inequality, at 4.4 percent. For Sub-Saharan Africa, the predicted growth in poverty was positive, mainly a result of worsening inequality, and where economic growth had no effect in reducing poverty since its average was zero during the period. The experience of Latin America was similar to that of the African countries, low growth and worsening inequality that generated a high rate of growth in poverty. On the other hand, there was a significant decline in poverty in the Asian sample (China, India, Malaysia, Pakistan, Philippines, Sri Lanka). The increase in inequality was sizeable but was more than compensated for by a large growth effect that dominated the negative distributional effect. However, the findings indicate that group averages do not reflect the behaviour of individual countries. There are significant differences in the behaviour of countries within the four groups.

Policies for poverty alleviation should not be based on the average of group behaviour. It is true that models that stand the empirical test provide for a better overall understanding of linkages. But to alter these behavioural linkages, a better understanding of the contextual setting is required. Inequality may or may not lead to conflict and increase the incidence of poverty. Outcomes depend to a large extent on the political system, the presence of efficient and adaptive institutions, the initial levels and depth of deprivation, the extent of social stratification, and growth prospects. Even the pivotal role of growth in reducing poverty may be inhibited depending on the structures of these socio-political parameters. The recent introduction of some of these parameters, although crudely measured, in modelling poverty based on cross-country analysis is a step forward in elucidating the dynamics of poverty. The effects of these socio-political factors have been shown to be statistically significant in many studies. However, the interpretation of these findings for policy formulation proved to be difficult and controversial [cf. Squire (1999)].

Figure 2.1: Dynamics of Poverty in Four Regions (Predicted annual average change in poverty for 1975-96)



Source: Based on Figure 4.2, in Ali and Elbadawi (1999).

Developing countries in general, including most Islamic countries, are in the midst of basic economic-demographic transformation that presents potentialities and challenges. Potentialities are represented by examples of countries that were able to move into a sustainable development path that significantly reduced the incidence of poverty. In most cases, this has been achieved by strengthening the determinants of long-term growth, mainly egalitarian quality education, efficient institutions, and the adoption of the Rule of Law and Isonomy in governance. The absence of these structural conditions, leads to lower growth, the higher incidence of poverty, and the erosion of progressive ethical systems [Sirageldin (2000)]. Poverty-alleviation policies should be viewed in this dynamic context of interaction between growth prospects and progressive values.

Such a perspective is not unique to the analysis of poverty. In my view, the failure of the UN decade of development (1960s) that viewed shortage of capital as the main constraint to development, or more

recently, the difficulties encountered by oil economies to achieve sustainable development although having no capital constraints is largely a result of overlooking the negative externalities associated with the style of their development strategies [for a discussion of the oil economies see al-Ebraheem and Sirageldin (2000)]. It is instructive to reflect briefly on the development paradigms of the 1960s. There is a parallel between that experience, its impact on the path of development of the then less developed countries, and current attempts at poverty alleviation. The parallel is striking, especially in the patterns of its negative externalities. Both seem to view the problem at hand as a transfer problem, with no critical assessment of the impact of such an approach on individual motivation, social values, or governance. Although with good intentions, the development outcomes of the 1960s development decade were not necessarily positive. The problems with development strategies and efforts of that era were well articulated by the late Harry Johnson [Johnson (1965), pp.68-100].

Briefly stated, capital accumulation was viewed as the crux of the development problem. This view was supported by three major sources. These are the intellectual tradition of English classical economics, a misreading of the Soviet experience with economic planning, and the attempt to bias the analysis of the causes of underdevelopment towards explanations that do not infringe on human self-respect. In this respect, lack of capital, as an explanation of poverty implies no slur on human dignity while lack of application and ingenuity, especially when associated with increased training and human capital formation, tends to increase such a slur. It took more than a decade of experience with development problems to discover that development is not a simple matter of generating enough capital investment. It is a far more complex problem of generating the human skills and knowledge required for working with and managing the capital and adapting to new technologies and innovations, and this in turn requires a transformation of the

economic, social, legal, and cultural environment. Without such transformation, negative developmental patterns emerged. These ranged from substituting productive investments by unproductive spending on trappings and symbols – large armies, impressive and costly public buildings and monuments, the evolution of double standards in national and international relations, and the inhibition of self-reliance. All lead to the failure of the development decade for most developing countries. It is easy to see the parallel with the evolution of poverty reduction strategies by substituting poverty for development in the above discussion. We now turn to a review of current efforts at poverty alleviation, their challenges and their adherence to the Islamic ethical system in an attempt to rank poverty-reduction strategies.

4. VALUES, POLICIES, AND THE ISLAMIC ETHICAL SYSTEM

In the previous discussion we focused on the multidimensional and dynamic nature of poverty. Poverty is viewed as part of the larger socio-economic and political system. In this perspective, it is possible for poverty-reduction policies, if not adequately designed, to produce sizable negative externalities that, after working themselves into the system, dominate the positive impact of policies and produce a net social loss. In this Section we elaborate on this proposition. We focus our discussion on what we label as investment poverty-reduction policies. These are policies whose outcomes are expected to increase production and productivity for present and future generations. Other policies, based on transfers, designed mainly to increase the current consumption of people who are poor and lack the capacity to produce, are not examined in the present analysis, although the successful implementation of such policies is expected to increase total social welfare. This is the case, since the obligation to support this group of the poor concurs with universal ethical values and should be

considered a private and public duty in any civilised society. On the other hand, the success of the former type of policies should lead to a reduction in the burden of taking care of the latter group. Furthermore, there are two main types of poverty: transitory and chronic, that require elaboration.

Transitory poverty arises as a result of temporary loss of job or own business, a bad harvest, or voluntary migration seeking better economic conditions. People with temporary layoff, accidental bad harvests, or migrants may expect to live temporarily in poor conditions but expect their situation to improve. The same is true for people who sacrifice present consumption to invest in additional education and training. This pattern of life-cycle dynamics characterises a vibrant and dynamic society. However, it is possible that expectations do not materialise, a consequence of lack of access to credit or constrained mobility. As a result, the depletion of physical or human capital assets goes beyond the potential for their replacement while the negative effects are being transmitted to future generations with negative consequences to health and education status. These are social consequences since they inhibit the full development of children and other members of society. In such circumstances, people are considered to move from transitory to chronic poverty status that increases economic vulnerability and could lead to famine situations. The acceleration in such movements is a signal for increased socio-economic difficulties. Chronic poverty relates to those who are poor because they do not have the means to get out of poverty either because of environmental conditions, involuntary migration, financial, health, or social mobility constraints. This latter group represents the core of poverty analysis discussed earlier and raises fundamental challenges to the development of strategies and policies for poverty reduction especially when dealing with the intergenerational transmission of poverty, poor families or households with large family size. Unfortunately, as mentioned earlier, data on poverty are not designed to present these fundamental dynamics.

4.1 Broad Strategies for Poverty Reduction

The previous analysis indicates that poverty is a result of diverse factors and suggests three broad strategies for its reduction: growth, distribution, and the development of socio-political institutions and arrangements dealing with the poor. These broad strategies, although interrelated, could have different impacts in the long-term and in the immediate and short-terms, on the sustainable reduction of chronic, transitory and other types of poverty. They should be examined as a coordinated package and viewed as essential elements of an overall development strategy. We feel however, that effective growth strategies with a built-in equitable opportunity mechanism should serve as the foundation for sustainable poverty-reduction policies. As discussed below, these proposed strategies are in harmony with the Islamic ethical system outlined earlier.

The presence of poverty on a large scale is associated with lack of development. This fact is evident from reading through the United Nations Human Development Reports. As indicated earlier, countries that were able to achieve a sustainable reduction in poverty are those that achieved sustained levels of economic growth and development. Notable examples are Korea, Malaysia, and Singapore among others in which poverty has been reduced to below 15 percent. Indeed, poverty continues to exist in all high growth and industrialised countries. But because of the relative low levels of poverty combined with the presence of high incomes, a favourable demographic environment, and effective institutions, policies to reduce poverty are relatively less costly and more effective. Growth strategies are long-term processes by nature. To be successful, growth strategies focus on enhancing the long-term determinants of economic growth: quality education, health and other determinants of human capabilities, productive investment, efficient market behaviour, and the development of democratic practice and the Rule of Law.

The poverty-reduction component is embedded in this framework as long as it adopts egalitarian policies for the development of human capabilities and the distribution of opportunities. It is this part of the

growth strategy that is essential for sustainable poverty reduction. Equitable investment in education and its quality especially at the basic level for all members of the young cohorts is a necessary condition if countries are to escape the vicious circle of poverty. Sufficient conditions are the promotion of an environment for healthy competition, productive opportunities, and fair governance. But the development of such an environment requires consistent moral guidance. It is well known in recent psychological research that moral development and identity is fostered by multiple social influences that guide a person from early childhood in the same direction. Thus, while parents, the education system, and the immediate community provide the basis for industry and independent thinking in the formative years, it is transparency in government, isonomy in the Rule of Law, and other democratic practices and institutions that provide the needed support and reinforcement beyond these formative years. The transformation of the next generation into a productive, committed, and internationally competitive force, essential for the development of a healthy society and its survival in the present global environment is nothing short of a true revolution for most developing countries. It is this vision of 'development with productive equity' that I believe is the essence of a poverty-reduction strategy based on the Islamic ethical system. In this context, not only the prevailing growth strategy, but also all distributional strategies should be designed, monitored, and evaluated according to these principles.

4.2 Strategies and the Islamic Ethical System

The four basic tenents of the Islamic ethical system mentioned at the beginning of this paper indicate that Islam views society as a unified entity, a general equilibrium approach to development. It also provides for an adaptive approach to policy formulation depending on the changing technological and knowledge environment. There is freedom to develop details based on the basic concept of 'equilibrating forces' within and across generations. Furthermore, there is no forcing

of action. Individual freedom and human dignity is supreme although subject to the axiom of responsibility. This implies that decision makers, given the right to acquire capabilities and opportunities, make their own allocation decisions and bear the consequences. Society is committed to provide the necessary environment for equitable access to capabilities and opportunities as well as transparency in government. The burden of utilisation is on the individuals. Furthermore, there is a social aspect of every asset owned or managed by private or public entities. The implication is that excessive consumption of present versus future generations is not encouraged and should be socially resisted. The combination of these axioms indicates that policies should not develop 'dependency' or non-productive activities. The poor should not be institutionalised over their life span or across generations. Policies based on transfers that do not shift the poor from their dependency status should not be adopted except in cases where such a shift is not feasible. The ethical foundation of this analysis is similar to that embedded in the principles of Islamic finance that prohibit payment or receipt on borrowed funds that do not allow a just partitioning of risk and return, in so far as it does not allow for a 'permanent' mechanism of risk transfer.

Islamic ethics also rely on individual and private action to reduce poverty. The most obvious is the institution of *zakāh*. *Zakāh* institutionalises the principle of care on the individual and community level, essential for the cohesiveness of Islamic communities. Policies that promote equitable growth, discussed above, have the same principle. It is part of the overall Islamic Bill of Rights and Obligations.

5. CONCLUDING REMARKS

In this paper, we have focused on the challenges of eliminating poverty in developing societies. We highlighted the difficulties of conceptualisation and measurement, essential for developing and monitoring policies. Poverty is a consequence of lack of growth and inequality. We focused on the growth component since it is essential

for providing the opportunities for those in poverty. Equality is necessary but should be viewed in the context of a long-term equal development of capabilities and access to opportunities. This view, we reasoned, is in accordance with the Islamic ethical system where the dignity of human beings is not based on dependency. Furthermore, there is a pivotal role for individual commitment to contribute to poverty alleviation. This is done through the institution of *zakāh* that should be viewed as a complement to social commitment. In summary, Islamic ethics support a poverty-alleviation strategy that is based on the principle of *promoting economic growth with productive equity*.

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CHAPTER 3

Poverty Elimination in an Islamic Perspective: An Applied General Equilibrium Approach#

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and
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1. INTRODUCTION

The closely related problems of abject poverty and income inequalities have been the focus of debate at all times and on every intellectual and political forum. Any programme that bypasses the twin issues cannot be considered as a plan for economic development. The socio-economic system of Islam suggests a permanent solution to eradicate the evils. On the one hand, it strictly

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prohibits all forms of exploitation (with the institution of interest at the top); and on the other hand, it devises concrete measures to ensure the flow of resources from the rich to the poor members of society. Abolition of interest and enforcement of *zakāh* are considered to be the hallmarks of public policies in an Islamic state.

The contemporary Muslim world faces a number of socio-economic problems and Pakistan is no exception. Phenomena like mass poverty and income inequalities, fiscal deficits and large stacks of debt have deformed its image. The nation embarked (imperfectly) upon socialist and capitalist models, from time to time with changing perspectives. Every experiment terminated with new issues and further grievances for the masses. A genuine model that is compatible with the ideology of Pakistan and supported by public demands, remains to be tested. It requires a restructuring of the prevailing set-up according to Islamic principles. The term 'Islamisation' is used to symbolise the steps taken in that direction.

There seems no scope for econometric investigation to verify the validity of claims put forward in favour of Islamic economic planning since a fully-fledged working model is missing from the real world economies. Fortunately, the computable general equilibrium (CGE) framework can be utilised as a genuine alternative to highlight the impact of policy reforms oriented towards the replacement of debt-finance by equity-finance in business transactions and the enforcement of *zakāh* as the instrument of redistribution. An attempt has been made on these lines that provides empirical support to Islamic economic theorising. The model is designed to study the implications of an Islamisation programme for the economy in terms of various indicators. The paper focuses on the impact of the concerned parametric changes on poverty and inequalities.

A computable general equilibrium (CGE) model is employed to represent the economy of Pakistan as depicted by the data for the fiscal year 1989-90, chosen as the base. The model employs two

primary factors, labour and capital. The supply side consists of commodity producing sectors including public services and transactions with the rest of the world. The demand side comprises households, the government and investment sector. The data is derived from official sources. Parameters of the model are obtained partly from the available literature and partly through calibration. The data is fitted to the model and the first simulation, which replicates the base year data, and provides the benchmark for subsequent analyses.

Four perspective plans are designed to facilitate comparison among the estimates projected in the future; namely: maintaining the status quo, the introduction of *zakāh* only, the replacement of interest by profit-sharing, and a full-scale Islamisation plan that admits *zakāh* and profit-sharing simultaneously. The rest of the institutions and structures of the base year have to remain intact. It is shown that a full-scale Islamisation plan ensures the best results within a moderate span of time as compared to maintaining the existing set-up or going through imperfect experimentations in the desired direction. The paper establishes the viability of full scale Islamisation of the economy on efficiency and equity grounds.

A brief review of the relevant literature is given in the following section. The next two sections deal with model specification, data and parameters. The main results are discussed thereafter. The final section is reserved for conclusions.

2. REVIEW OF LITERATURE

The present study focuses on the implications of policy changes relevant to Islamisation for the economy in general and for income distribution and poverty in particular. The available literature in the areas concerned mainly focuses on establishing the poverty lines, estimating the incidence of poverty and projecting the profile of income inequalities in Pakistan. The studies containing programmes for reducing inequalities and/or eliminating poverty are quite scarce.

The following is a brief account of the available literature dealing with these issues.

2.1 The Incidence of Poverty and the Degree of Inequalities

The extent of poverty and the degree of inequalities in personal distribution of income has been a live topic of debate on socio-political forums, particularly in the underdeveloped world. Economists are concerned with the estimation of poverty lines and inequality coefficients so as to verify the effectiveness of public policies concerned with development planning. A number of studies have been conducted in the area using Pakistani data. We briefly discuss two studies conducted recently that are relevant for our purpose. Both, in turn, have summarised the results of important studies conducted earlier on the subject.

1. Nasim et al. (1995): In this study, poverty lines are estimated using grouped data from the Household Income and Expenditure Survey (HIES) 1984-85, 1987-88 and 1990-91. The study adopts Foster, Greer and Thorbecke (1984) measures based on an estimated caloric expenditure function: $C = a + b \log E + u$, where C denotes the caloric intake per adult equivalent and E is monthly consumption expenditure per adult equivalent. The assumed cut-off point is 2550 calories per adult equivalent as established in Khan and Khan (1985).[1] The document shows poverty lines for 1984-85 [estimated by Ercelawn (1990)] and for 1987-88 and 1990-91 by the authors. The following extract from a table shows the income required to maintain the minimum nutritional requirements of the household concerned for overall Pakistan. The figures are expressed in rupees per month:

[1] The estimates of calorie requirements by Khan and Khan (1985) are based on micronutrient data information, published by the Planning and Development Division, Government of Pakistan (1980).

1984-85		1987-88		1990-91	
Per adult	Per capita	Per adult	Per capita	Per adult	Per capita
Rs.185.00	Rs.150.00	Rs.244.11	Rs.190.47	Rs.320.42	Rs.256.33

2. Jafri and Khattak (1995): This study adopted the basic needs approach to estimate the poverty lines based on HIES data for 1990-91. This includes the cost of minimum expenditure on clothing, housing, health, education, transport, socialisation, recreation etc., besides food. So far as the cost of nutrition is concerned, it considers the minimum requirement of 2550 calories intake per adult per day, which is equivalent to 2354 calories per capita in Pakistan.[2]

Table 3.3 of the study shows per capita per month expenditure of an average household for rural and urban areas in Pakistan just sufficient to fulfil the minimum requirements. Assuming a share of 32 percent of urban and 68 percent of rural in the total population, the estimated poverty lines for different years are as follows:

1985-86	1986-87	1987-88	1990-91
Rs.203.30	Rs.224.30	Rs.234.40	Rs.323.00

2.2 Empirical Models with the *Zakāh* System

The institution of *zakāh* is regarded as the backbone of fiscal policy in an Islamic state. Although the institution does exist in Muslim societies, however, a mechanism for its collection and disbursement at the state level is missing in most Muslim countries. Therefore, empirical studies for real economies are rare as well as limited in scope and coverage. The following are a few examples that incorporate *zakāh* in the system and evaluate its effects.

[2] The authors refer to the FAO/WHO (1985) report of a joint expert committee, Geneva, entitled: "Energy and Protein Requirements".

1. M. Fahim Khan (1986): this model is designed with the objective of testing the contention that the level of saving will be lower in an Islamic framework than if the same economy operates on a non-Islamic basis. Two arguments are offered to nullify this hypothesis – that aggregate consumption level under the Islamic premise will be lower than that of an un-Islamic premise, and even if there is any chance of a short-run decline in the aggregate savings due to enforcement of *zakāh*, this adverse effect will soon be wiped out and the long-run savings as well as the growth rate will be higher. Intuitively, these arguments follow from the income distribution effects of *zakāh*, which causes the poor sections of society to enter ultimately into the group of savers as their living conditions improve.

The model incorporates *infāq*[3] in the consumption behaviour of Muslim households and derives the macro consumption function for an Islamic economy. A simple macroeconomic model is formulated to trace the effects of *zakāh* on savings, growth and income distribution. The model is then used to study different cases under different behavioural assumptions through numerical forecasts. The results are then compared with the case of secular consumption function and it is shown that an Islamic model with *zakāh* and/or other virtues shows better results.

2. Shirazi et al. (1994): this study aims at estimating the effects of *infāq* on poverty alleviation using data from HIES 1987-89 at a disaggregate level. The study uses different estimates of the extent of poverty and relies on at least three measures for its incidence, namely: the Head Count, the Poverty Gap and the Foster-Greer-Thorbecke, FGT, (1984) measure. The expenditure-based measure is converted into income-based measure through a log-linear function. The methodology is simple; the incidence of poverty is calculated

[3] Spending money and commodities to help the poor and destitute as also in other avenues with the sole objective of gaining Allah's favour is called *infāq*. It is a wider concept and includes both compulsory spending as well as voluntary contributions. *Zakāh*, being compulsory, is a component of *infāq*.

through the percentage changes in poverty measures with and without *infāq*. The impact of other qualitative variables (like the household size, education level of the head of family and the number of earners in the family) on the incidence of poverty is also studied. This study was followed by a more elaborate study [Shirazi (1996)] that evaluated the performance of *zakāh* and *'ushr* system in Pakistan using recent data.

2.3 General Equilibrium Modelling Practice in Pakistan

The earlier work focused at construction of the input-output tables for the economy [PIDE[4] (1976-77)], Social Accounting Matrix (SAM) [Cohen and Havinga et al. (1985)], and inter-industry relations in Pakistan [S. Aftab Ali (1985)]. The 1984-85 SAM and input-output tables were developed at the Federal Bureau of Statistics (FBS), Islamabad in collaboration with the Netherlands government and published in 1993. We find only two CGE models dealing with the Pakistani economy.

1. AERC (1994) Model:[5] The model is constructed to evaluate the impact of budgetary reforms advised by the IMF on economic growth, environmental quality, industrial structure and land improvement. These reforms are often referred to as the Structural Adjustment Programme (SAP). Foreign assistance from international agencies to Pakistan is now tied to the implementation of the programme in letter and spirit. AERC (1994) is in fact a three-piece model. The first is a highly aggregated macro growth model to predict the long-run effects of the reforms on economic growth and environmental quality. The second piece consists of a

[4] Pakistan Institute of Development Economics, Islamabad.

[5] Developed in 1994 at the Applied Economics Research Centre, Karachi University in collaboration with the Harvard Institute for International Development, Cambridge, MA, under the title: Economic Reforms and the Environment in Pakistan, AERC, Research Report No. 102, October 21, 1994.

short-run CGE model that is of some relevance to our work. The third part is an extended form of the Indus Basin Plan (revised) model originally developed by the World Bank in 1963. This linear programming model has been used to study the impact of the reforms on cropping patterns, ground water balance, salinity and agricultural produce in the irrigated areas of Punjab and Sind. The results of all the three models are then integrated and conclusions derived.

The CGE sub-model of AERC is based on 1984-85 SAM of the FBS to incorporate eight production sectors, two factors and four institutions. The model is used to examine the impact of changes in tariffs, direct taxes, budget deficits, exchange rates, and different policy mix plans as required by SAP. The model is claimed to be internally consistent. However, it lacks dynamic qualities and shows no response to population growth or capital accumulation over time.

2. Shafique Dhanani (1988): this is a SAM based CGE model and uses the PIDE 1975-76 input-output tables and CMI (Census of Manufacturing Industries) for 1983-84 to compile a SAM for use in the analysis. It consists of nine production sectors, four household groups and nine consumer goods incorporated in the institutional accounts. The production and consumption behaviours are specified with CES and LES functions respectively. There is no explicit role for the government. The model is built for static analysis to see the multiplier effects of various fiscal policies.

3. MODEL SPECIFICATION

A dynamic version of computable general equilibrium model is specified, with all the neoclassical assumptions intact. The parameters of the model are selected such that the model replicates the observed data on the relevant variables for the base year. We mainly draw upon Serra-Puche (1979), Hassan Imam (1983) and BFSW (1985) models. However, we do not follow these models very strictly. We deviate

where necessary, both in specification and methodology with due rationalisation.[6]

3.1 Production Relations

The supply side of the economy consists of 'n' commodity producing sectors. The production function for a typical firm in sector j, may be given by:

$$Q_j = \min(A_j, VA_j), \text{ where } j=1,2,\ldots,n \qquad (1)$$

It states that the output Q by the sector concerned bears a fixed relationship with the inputs, raw material and factor services, needed in the transformation process. As such the requirements of inputs per unit output may be written in the condensed form:

$$q_j = \min(X_{ij}/Q_j, VA_j/Q_j) = \min[a_{ij}, v_j(l_j,k_j)] \qquad (2)$$

The first argument A_j, denotes a column vector of intermediate input X's, required in fixed proportions for the total output. The minimum quantity of an input from the 'ith' industry required per unit output of the 'jth' industry is denoted by $a_{ij}=X_{ij}/Q_j$. It occupies a unique position in the Technical Coefficient Matrix [A], which is a square matrix of order (nx n), with rows depicting the transactions from the sector of origin 'i' and the columns indicating the demand by the sector of destination 'j'. The Activity Analysis Matrix, given by [I - A], is derived from the technical coefficient matrix. The elements along the principal diagonal indicate the net output of the sector concerned and the off-diagonal elements with negative signs indicate the inputs. The inverse of this matrix, often called the Leontief Inverse, is useful in deriving the activity levels by considering the final demand for output of the sectors concerned:

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[6] The detailed version of the model may be provided to interested readers on request.

$$Q_j = [I - A]^{-1} FX_j \tag{3}$$

The second argument in the production function represents the value added relationships of the primary inputs, capital and labour services, with output. The proportion of value added in the total output remains constant, although the factor services are the variable on account of substitution possibilities and the variable prices of factors. Thus the coefficient $v_j = VA_j/Q_j$ remains constant like a_{ij}.

The value added in a particular firm/sector may be represented by various technologies depending on the availability of data on elasticity parameters. In most cases either a CES or a Cobb-Douglas function is used for their desirable properties. The sector concerned hires the services of capital and labour factors, owned by the households, from the market. A typical firm within the sector concerned may be assumed to be price taker and cost minimiser subject to a given level of output so as to meet the market demands. The constrained optimisation problem may be stated as:

$$\text{Minimise } C_j = P_k K_j + P_l L_j; \text{ subject to } VA_j = P(Kj, L_j) \tag{4}$$

where $j = 1,2,......, n$; and P_k, P_l, stand for rental prices of capital and labour.

This behaviour leads to factor demands per unit of value added. The derived factor demands depend on the market prices and the solution algorithm finds these values under competitive conditions.

$$l_j = f(P_l) \text{ and } k_j = f(P_k) \tag{5 a,b}$$

3.2 Consumption Behaviours

The households derive their income by selling the services of labour and capital factors to ultimate users against remunerations determined by market forces. A fraction of the income may be saved

for future needs and the rest may be allocated to current consumption. This behaviour leads to demand for commodities meant for consumption and/or investment. Therefore, the behaviour of households may be studied in two stages.

3.2.1 *Inter-temporal Decision-making*

In the first stage of decision-making, a typical household is supposed to allocate its disposable income between present and future consumption. The part of income invested in the current period is expected to generate income over time that will finance part of its consumption in the future. Therefore, C_f represents the stream of future consumption [see Laviatan (1966)].

$$C_f = f(C_1,C_2,\ldots\ldots,C_t) \tag{6}$$

It is customary to use the rate of return on savings, given by 'r', as proxy for the rate of time preference of the consumer to discount future receipts. The present real value of the stream of future consumption can be denoted as:

$$P_f = \frac{P_1}{(1+r)^1} + \frac{P_2}{(1+r)^2} + \ldots\ldots + \frac{P_n}{(1+r)^n} \tag{7a}$$

$$P_f C_f = \phi \sum_{t=1}^{\infty} C_t, \text{ where } \phi = \frac{1}{\Pi (1+r)^t} \tag{7b}$$

As such, the value of savings/investment equals the value of the present worth of future consumption at the margin:

$$P_s S_o = P_i I_o = P_f C_f \tag{8}$$

The household may be assumed to make 'myopic expectations' about the future, having an infinite time horizon. Thus:

$$P_t = 1/A(1+r)^t \qquad (9)$$

It can be seen that P_t tends to 1/r as t tends to infinity. The symbols P_o and P_i used in the above relations for the price indices of the composite commodities meant for consumption and investment respectively, need to be identified for the current period.

Keeping in view the above discussion, the optimisation problem of a typical household (h) may be stated as under:

$$\text{Max. } U_h = U\,[\,C_o, S_o\,]_h \quad \text{s.t. } P_oC_o + P_sS_o = Y^d \qquad (10)$$

where Y^d is the disposable income and C_o, S_o denote composite commodities for consumption and saving respectively. The inter-temporal preferences of the households may be specified in terms of CES/LES functions in which the elasticities of substitution between current and future consumption play an important role. The resultant demand functions are obtained with incomes and prices of composite commodities as arguments. The nominal expenditure incurred on consumption and saving goods may be expressed in terms of P_oC_o, P_sS_o:

$$C_o = f\,(\,Y^d, P_o, P_s)_h, \quad S_s = f\,(\,Y^d, P_o, P_s)_h \qquad (11\ a,b)$$

The society may include a sizable proportion of households whose incomes might not be sufficient to finance even their present consumption needs. The behaviour of a typical poor household can be specified accordingly:

$$\text{Max. } U_h = [(C_o - B_o), S_o] \quad \text{s.t. } P_oC_o + P_sS_o = Y^d \qquad (10)^*$$

where B_0 is a subset of C_0, denoting the value of consumption goods necessary for sustenance. The said behaviour leads to the demand functions in the usual way which may also be expressed in terms of $P_0Z_0 = P_0C_0 - P_0B_0$. The term P_0Z_0 denotes the consumption level of the household over and above the basic needs. $Y^d - P_0B_0$ then shows the income available after fulfilling such needs. It is just possible that $Y^d - P_0B_0$ is zero or negative for some poor sections of the society; and in case of strict inequality, the concerned household may be compelled to borrow to finance present consumption needs.

3.2.2 *Contemporaneous Consumption*

In the second stage of the two-nested structure, the household concerned is required to allocate further the fraction of income meant for current consumption among the commodities available to them at market prices. The optimisation problem may be written in condensed form as:

$$\text{Max. } U_c = U(X_1, X_2, \ldots\ldots, X_m)_h \quad \text{s.t. } \Gamma\, P_jX_j = M = P_0C_0 \quad (12)$$

$$\text{where } P_0C_0 = Y^d - P_sS_0$$

The sub-utility function U_c may assume specific forms; the Cobb-Douglas (CRS) being the most familiar. The resultant demand functions depend on the household's income and market prices. The composite price index P_0 for the households can be obtained by considering the expenditure function. The formal technique is to substitute the ordinary demand functions in the contemporaneous utility function. This gives the indirect utility function (V_h) with income and prices as arguments. The Expenditure Function (E_h) and the composite price index (P_0) can be derived from this relation. Likewise, the composite price index for the saving/investment commodity is a weighted function of the market prices of various items acquired for the purpose. These commodities add to the stock

of fixed capital by the end of the accounting period. Consequently, the price index can easily be derived.

It may be noted that the government provides 'public goods' to society free of direct user charge. As such these can be treated as exogenous arguments, and although consumers derive utility from these goods, they have not been explicitly included in the utility functions described above.

3.2.3 *Income Generation and Distribution*

Income is generated in the economy via the contribution of factors to the process of production. In nominal terms, it corresponds to the cost of production. The accrual of income to households or more correctly, personal distribution depends on the ownership rights enjoyed by the entities concerned as well as on the financial set-up which plays an important role. We discuss this aspect of the system in some detail.

3.2.3.1 Income generation

Households are assumed to own capital and labour endowments. Labour endowments include all human efforts offered against wage, either fixed or imputed. The labour force may be assumed to grow over time at a constant exponential rate 'n'. Capital endowments include all kinds of non-human assets. Endowments of land and other natural resources are assumed to be exogenously given. The production sector and governments hire the services of these factors at market rates. This mechanism gives rise to gross income of households:

$$Y \equiv C = P_k K + P_L L \qquad (13)$$

It is assumed that the savings are transformed into investment goods valuing $P_I I_0$ through the implicit intermediation of the banking

system and stock markets. Part of the current investment is consumed to replace the worn-out capital goods while the remaining is used to purchase new goods, which add to the stock of the fixed capital by the end of the accounting period. Each unit of capital good is expected to yield '8' units of capital services and each unit of these services bears a rental price P_k on selling the same to the ultimate user.[7] Thus, the value of services generated per unit of capital good is given by $8P_k$ and the total return on current saving/investment is given by $8P_kI_o$. The income so generated may be utilised to finance part of future consumption; the present value of which can be expressed using current prices:

$$P_oC_f = (8P_kI_o). \qquad (14\ a)$$

Multiplying both sides by P_i and rearranging the terms, we get:

$$P_iI_o8P_k = P_iP_oC_f\ , \text{ or } \quad P_iI_o=\{(P_oP_i)/(8P_k)\}C_f = P_fC_f \qquad (14\ b)$$

$$\text{so that: } \ P_f = (P_oP_i)/(\ 8P_k) \qquad (14\ c)$$

The rate of return on investment can be readily calculated as under:

Rate of return (absolute) $r=(8P_kI_o)/(P_iI_o)=(\ 8P_k)/P_i$ (15 a)
Rate of return (relative) $r\hat{}=(8P_k)/(P_oP_i)$,
(measured in units of consumption goods) (15 b)

It can be seen that $P_f = (P_oP_i)/(8P_k) = P_o/r$ (from 14c and 15a)

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[7] The share of capital in nominal GDP is B=8PkK/VA which reflects the distribution aspects. The economy-wide capital-output ratio reflecting the production side is given by v=K/Q, where Q denotes the total output net of taxes. Then, the relation (B/v)*(VA/Q) indicates the number of units of services (8) produced by each unit of capital stock during the accounting period. Pk is assumed to be unity in the benchmark equilibrium.

3.2.3.2 Income distribution

There may not be any severe problem in the distribution of wage income among households. However, the distribution of profits or net return to capital may not be strictly proportional to the household's share in capital stock and investment. This is because the existing financial system discriminates between the return on bonds and equities, as well as within equities in terms of ordinary and preferred shares. This needs some explanation.

Households investing their savings through proprietorship, partnership or by the purchase of equities/stocks of business firms are entitled to the (*ex-post*) rate of return 'r', which is variable and determined by market forces. Alternatively, households investing in bonds or depositing their savings in banks are entitled to an exogenously given (*ex-ante*) or fixed rate of return given by 'r*':

$$r^* = (8P_k)/P_i^* \text{ or } \quad P_i^* r^* = 8\,P_k \qquad (15\text{ c})$$

where P_i^* is the acquisition price of the investment good from the purchaser's point of view. This is exogenously given due to the fixity of the rate of interest as compared to P_i, which is the price of investment composite determined by market forces. Put differently, the number of units of services per unit of capital stock in the fixed return system, given by '8*', may be different from the services actually generated in the market.

$$\text{Therefore,} \quad r^* = (8^*P_k)/P_i \qquad (15\text{ d})$$

In case $r = r^*$, which is just a matter of chance, both bond and equity holders get the same return. On the other hand, if the market rate of return happens to be different from the fixed rate, then equity holders have either to bear a loss or are entitled to super normal profits. The excess value, is given by:

$$\pm XV = \{(r-r^*)/r^*\}\{P_i^* I_o\} \tag{16}$$

We may define an 'initial index of wealth' for each household and assume that the aggregate wealth in society identically equals the value of physical assets/capital stock. For some poorer sections, this index may be zero or negative, thereby showing the outstanding debts they own. The excess value as discussed above, will be added to the indices of wealth of the business owners by the end of the accounting period. The value of capital stock or total wealth should, however, be distinguished from the value of services generated by the capital stock. All savings translated into investment during the current period should add to the stock of capital and simultaneously to the index of wealth by the end of the accounting period taking care for depreciation allowances. Thus, both the capital stock and wealth grow over time at the rate determined by the market forces that determine the flow of savings.

The gross income of the household concerned then comprises wages and returns from capital assets (rents, rentals, royalties, interests and dividends). If the income tax rate is t_y, the basic tax rebate is B, and the transfer payment/receipt is R, then the disposable income of a typical household, is given by:

$$Y^d = (1-t_y)(Y - B) \pm R \tag{17}$$

3.2.3.3 Public revenues

The government receives its share in the form of tax and non-tax revenues. Tax revenues include taxes on personal incomes and wealth/property, corporate profits and taxes on commodities. The non-tax revenues include the share in income from property and capital stock held by the government. Besides, the government may run deficits and create additional purchasing power to finance its expenditure.

Total tax revenue is given by:	$TR = IT + PT + ST$	(18 a)
Income tax (personal)	$IT = t_y \Gamma_h \Gamma_{pop} (Y_h - B)$	(18 b)
Corporate income tax	$PT = t_k \Gamma_i 8P_k K,$	(18 c)
Commodity tax	$ST = t_c \Gamma_j P_j FX_j, \quad j = 1,2,\ldots,n$	(18 d)

where t_y is the tax rate, Y_h is the household income falling within group 'h' and having a given population represented by 'pop', and 'B' is the basic exemption limit. Likewise t_k is the profit tax, '$8P_k K$' is the operating surplus in the 'ith' incorporated industry, whereas t_c is the commodity tax (sales, excise, customs) rate and '$P_j FX_j$' is the value of final demand for the output of the industry concerned.

3.2.4 *Alternative Specification for an Islamic Economy*

Financial transactions on the basis of a pre-determined and certain rate of interest, payable to the lender, with all the risk and uncertainty in business to be borne exclusively by the borrower, are strictly prohibited in an Islamic economy.[8] In technical terms, the system does not allow discrimination between r and r* or equivalently between P_i and P_i^* shown above. The total profits accrued to the business are to be distributed among the partners in proportion to their investment. Of course, every partner is supposed to face the risk and uncertainty equally. This is termed as the profit and loss sharing mode of business or *mushārakah*. Another mode of coordination in business permissible in the Sharīʿah, is the *muḍārabah* or Principal-Agent contract. For the sake of manageability, however, we restrict ourselves to the equity-participation mode to substitute the debt-based financing mechanism in the model.[9]

[8] This prohibition can be equally rationalised by referring to the prevailing distribution mechanism in which ordinary savers, although contributing a sizable proportion to the aggregate investment, are paid according to a minimal rate of interest whereas the owners of business appropriate most of the excess value.

[9] Financial institutions may assume the shape of investment companies floating their equities in stock markets like other business companies. Alternatively, they may be allowed nominal service charges for their intermediation role.

The Islamic system of redistribution operates via the institution of *zakāh*. It is admissible at a constant proportional rate to the stock of wealth held by well-to-do individuals by the end of every year, after allowing for an exemption limit called *niṣāb*. The revenues so generated are distributed among the poor and destitute called *mustaḥiqqīn* (deserving) according to their needs. This enhances the index of wealth of the poor class and entitles them to a higher level of income in the following periods. In the context of our model, we allow an instantaneous transfer of assets from rich to poor under this programme by the end of the accounting period.

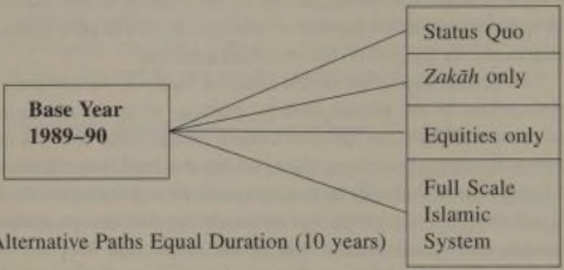
The prime objective of the present study is to evaluate the implications of the Islamisation programme in terms of economic indicators. The process involves certain fundamental changes in the system through appropriate public policies that lead to the elimination of interest from financial transactions and the enforcement of *zakāh*. To achieve this objective, we introduce the following parametric changes on the distribution side of the model. We keep the basic structure of the model (regarding the behaviours of consumers and producers) unchanged.

1. *Zakāh* at a constant proportional rate of 2.5 percent, chargeable to the household's financial wealth[10] over and above the exemption limit by the end of each accounting period, is incorporated in the model leading to transfer payments/ receipts among the individuals.
2. The total return on capital given by $A_k = r\ K$ is distributed among shareholders in proportion to their respective shares such that $A_k = E_i$, where 'i' is the share of the ith household. The average rate of return to investment given by $r = 8\ P_k / P_i$, as determined by market forces, may vary over time.

[10] Although *zakāh* is chargeable to the value of all forms of wealth, both hidden and revealed, from the Sharīʿah standpoint, we may, however, confine ourselves to revealed wealth or capital assets only for analysis in this model due to data constraints.

The proposed scheme is expected to leave the economy with a more equitable distribution of income, an enhanced rate of savings and investment and a higher growth of GDP in the long run, besides an improved allocation of resources reflected by the price indices and utility levels.

Projection Scheme **Future Scenarios**



4. DATA AND PARAMETERS

General Equilibrium Models require comprehensive information on all aspects of the economy. The data should be disaggregated and consistent. Likewise, the researcher should know the values of all parameters of the model *a priori*. We discuss some of the important points.[11]

4.1 Data Considerations

We have selected the fiscal year 1989-90 as the base due to the fact that the latest input-output tables are available for this year (in

[11] The information regarding data and parameters used in this study can be provided to interested readers on request.

manuscript form). All the relevant information has been derived from published sources. The data has been modified and adjusted, where necessary, to ensure consistency.

The supply side of the economy is aggregated into 18 commodity-producing sectors, out of which 17 sectors are domestic and the last sector is devoted to transactions across borders. The data on inter-industry transactions is taken from Input/Output tables and the value added information is derived from National Accounts.

The household's information is derived from the HIES 1990-91, showing the allocation, distribution and sources of income. The households are aggregated into four groups according to their income and expenditure levels, namely low-income, lower-middle income, higher-middle income and high-income groups.

The demand side comprises ten composite commodities meant for consumption and a single composite good meant for investment. All these final products originate from the agricultural, industrial and services sectors of the supply side. Both the industrial and household commodities are abridged through a transformation matrix.

4.2 Parameter Estimates

As stated above, the CGE models need full information on the parameters of the behavioural equations. In this context, the elasticity of substitution parameters, both in consumption and production, are crucial. Unfortunately, the information on this aspect is very scarce, particularly in underdeveloped countries. We have assumed CES specifications for the value added functions for sectors where the elasticity parameters were somehow available in the literature. In other cases, like agriculture and services, the Cobb-Douglas specifications have been used.

The importance of the substitution parameter in the household's decision-making about present and future consumption increases considerably when the rate of return to savings becomes variable.

Therefore, we have considered the CES specifications to be appropriate for the inter-temporal utility functions of the households. However, this parameter depends further on the interest elasticity of savings as well as on the propensity to consume. We have derived the parameters concerned, following the approach of Hassan Imam (1983) and the BFSW model (1985). The contemporaneous utility functions of the households are represented by the Cobb-Douglas specification. The remaining parameters could be easily derived from the available information.

5. THE IMPLICATIONS OF THE ISLAMISATION PROCESS

Islamisation refers to the process of restructuring the socio-economic system prevailing in the Muslim societies according to Islamic injunctions. A series of reforms were initiated in Pakistan in the early 1980s in this direction. However, due to the inefficiency of administrative machinery and the inadequacy of relevant procedures, outcomes have failed to match the expectations of the people. This has created disappointment among the general masses. The claim that Islamisation can rescue the economy from the prevailing hardships sounds implausible to certain quarters that are sceptical about the viability of such a system. The present study attempts to clarify the point. It is directed at an appraisal of the 'expected' economic profile should the system switch over to Islamic norms. We adopted the CGE framework that fits the observed data for the year 1989-90 as a benchmark. We introduced the relevant parametric changes in the basic structure as discussed under the alternative specification, and analysed the long-run implications of the policies that comply with the Islamisation programme in terms of specific indicators. We considered the following four scenarios/plans for the purpose. The operation period for each is the same and the simulations for the first plan serve as the baseline for comparisons.

1. Maintaining the *status quo*, i.e. if the existing (base year 1989-90) policies and allocation and distribution mechanism operate as usual.
2. Administering only *zakāh*, as an instrument of redistribution among different sections of the society, while retaining all other institutions intact.
3. Substituting only the interest-based mode of transactions by the profit-sharing scheme in saving-investment behaviour, while keeping all other things unaltered.
4. Combining the above two options simultaneously in the models to study the consequences of full-scale 'Islamic' economic policies.

5.1 Assumptions and Procedures

The following assumptions/operating procedures have been maintained:

1. The prevailing (base-year 1989-90) structure of taxation and fiscal arrangement remains intact during the plan period. Likewise there is no change in the institutional set-up concerning the behaviour of consumers, business and other agents during the plan.
2. The long-run ratio of government consumption expenditure to GDP is assumed to be 0.13 (13 percent).
3. The fiscal deficit is financed through bank borrowing every year and the trade deficit is supported through borrowing from the private sector, domestic and international. Surplus on the revenue account, if any, is diverted to finance part of the development expenditure.
4. The long-run ratio of gross investment to domestic saving is 1.45. As such the gap between planned investment and saving has somehow to be filled by the government.

5. The present is connected to the future through saving-investment behaviour that leads to capital formation. The distribution of return to investment among households has been made in proportion to the shares they own under alternative Plans 3 and 4.
6. The effective labour force is assumed to grow at an exponential rate of 2.5 percent per annum, keeping in view the net growth rate of population and the rate of unemployment. However, the total number of households remains unchanged.[12]
7. The poverty line assumed for the base year (Rs.21068/-) may not be stationary but moving over time with an average growth rate of 2 percent per annum keeping in view the growth of real GNP per capita during the past decade. Similarly, the basic exemption limit (Rs.30000/-) assumed for personal income taxation in the benchmark will grow at a rate of 0.5 percent.
8. *Zakāh*, at a fixed proportional rate of 2.5 percent, is introduced in Plans 2 and 4. The levy is applicable to the gross wealth or capital assets owned by the households by the end of the accounting period. The exemption limit for *zakāh* is assumed to be Rs.15000, keeping in view the value of 77 grams of gold at 1989-90 prices. An arbitrarily fixed *zakāh* fund is introduced to initiate the programme. This will act as the basic reservoir for incoming and out-flowing revenues and keeps the entries concerned separate from the routine fiscal bill.[13]

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[12] As discussed earlier, our unit of address in all relevant considerations is the household (or its head) and not the individual.

[13] Low-income households whose disposable incomes fall below the poverty line are assumed to be entitled to *zakāh* to the extent that their basic needs are fulfilled at the margin in each period. In other words, they are paid an amount equal to their current debt obligations every year. Similarly, households in the lower-middle income group may be paid *zakāh* equal to the difference between their financial assets and the exemption limit for *zakāh* with the intention that they become well-to-do (*ṣāḥib-al-niṣāb*) at the margin by the end of the accounting period.

9. Investment in the public sector is primarily meant for infrastructure and social sector development. Only 5 percent of the public sector investment is assumed to be directly productive in the sense that it generates revenues in the periods that follow.
10. Government continues to honour its contractual obligations regarding domestic and international debt transactions. In simple words, it continues to pay interest at a rate of 12 percent on permanent domestic debt and at 3 percent on outstanding foreign debt.[14]

5.2 Comparative Dynamic Analysis

The future position of the economy projected by the model under alternative scenarios is readily available in numerical terms. In all cases, the economy starts from the same point of reference (base year) and operates for the same duration (ten years). We briefly discuss the comparative position by the end year.

5.2.1 *Macroeconomic Performance*

The future screen of the economy in terms of key macro indicators under the alternative policy options can be presented as under Table 3.1. The replacement of interest-based financing mechanism by profit-sharing schemes becomes operative from the very beginning of the initial year. All the figures are expressed in million rupees. The growth rates are shown in parentheses.

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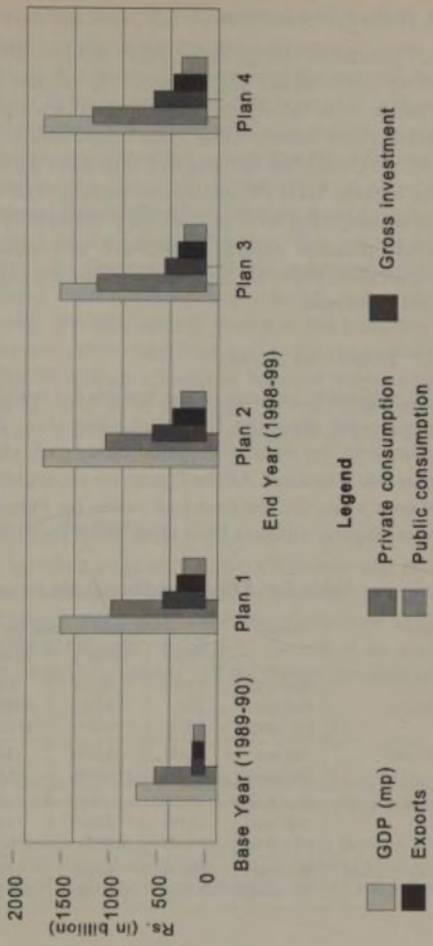
[14] This manipulation can be justified since the permanent domestic debt is in the nature of a dead-weight obligation with no real assets held in parallel that generate income to compensate the creditors via some profit/loss-sharing arrangement. The same is the case with outstanding foreign debt. The existing interest-based mechanism for public transactions may continue to operate in compulsion till there is an alternative arrangement.

The results convey the message that the performance of the economy will be much improved in all the revised plans as compared to the status quo (Plan 1). In particular, the key macro indicators like private consumption, public consumption, GDP, value added (overall and sectorial), saving and investment, etc. perform better under Plan 4. The comparative position is illustrated in Figure 3.1.

Table 3.1: Macroeconomic Performance

Item	Base Year (1989-90)	Plan 1 (Status quo)	Plan 2 (*Zakāh* only)	Plan 3 (Profit sharing)	Plan 4 (Full scale)
Private Consumption	648965.60	1118499.57 (0.0559)	1179053.72 (0.0615)	1145787.47 (0.0559)	1199772.80 (0.0607)
Public consumption	119918.41	240010.90 (0.0718)	267738.75 (0.0836)	236067.22 (0.0699)	261829.69 (0.0811)
Gross investment	135226.50	447015.67 (0.1270)	566756.82 (0.1540)	434045.26 (0.1211)	552470.24 (0.1484)
Exports	128603.88	301679.57 (0.0890)	352920.53 (0.1062)	299154.33 (0.0858)	349002.03 (0.1027)
Less Imports	197016.77	462162.84 (0.0890)	540662.25 (0.1062)	458294.27 (0.0685)	534659.24 (0.1027)
GDP (mp)	835697.62	1645043.87 (0.0701)	1825807.57 (0.0813)	1656760.01 (0.0685)	1828415.52 (0.0791)
Less indirect taxes	91221.78	199804.61 (0.0815)	229463.89 (0.0966)	199033.20 (0.0790)	227662.78 (0.0936)
GDP (fc)	744475.84	1445239.26 (0.0686)	1596343.68 (0.0792)	1457726.81 (0.0695)	1600752.74 (0.0795)
Private savings	93269.66	308286.67 (0.1270)	390866.78 (0.1541)	299341.56 (0.1211)	381013.96 (0.1484)
Fixed investment	112590.36	381874.75 (0.1299)	496764.70 (0.1600)	355594.28 (0.1228)	455846.64 (0.1510)

Figure 3.1: Macroeconomic Screen



5.2.2 *Welfare Implications*

Any parametric change due to public policy will alter the relative prices of commodities and, thereby, the relative position of the households when the economy returns to a new equilibrium. Some individuals may benefit while some others may be hurt. Different policies may, therefore, be compared in terms of their possible effects on the income levels, consumption patterns and utility gains of different households so as to assess their desirability from economic and social points of view. In this context, we compare the projected values obtained under the four plans and see the implications of the policies concerned.

5.2.2.1 Effects on income

The disposable incomes of the households belonging to various groups/classes show the following variations. The percentage deviation over the simulation period under each plan and for each group is also computed. All the figures are expressed in Rupees. It is noted once again that the base year values for Plans 1 and 2 are the same but slightly different from those given for Plans 3 and 4.

Table 3.2: Effects on Household Income

Plan	Period	Disabled Incomes per Household			
		Group 1	Group 2	Group 3	Group 4
Status quo	Base year End year (% change)	17581 20811 (18.372)	38356 45520 (18.677)	69895 134219 (92.029)	182591 624411 (241.972)
Zakāh only	End year (% change)	28173 (60.247)	47423 (23.639)	131072 (87.527)	711626 (289.738)
Profit-sharing only	Base year End year (% change)	17821 21310 (19.578)	40127 48607 (21.133)	73619 149979 (103.723)	177452 579405 (226.513)
Full scale system	End year (% change)	28570 (60.316)	49449 (23.480)	143081 (94.353)	675148 (280.468)

It is evident from the above that the disposable incomes of all the household groups increase more than proportionately in the three alternative plans as compared to maintaining the status quo plan. Further, an increase in the income level of the poor and lower-middle income households during the alternative plan periods is easy to understand, but it is very interesting to note that the incomes of the higher-middle and the rich classes also increase over the period under the revised schemes (specifically Plans 2 and 4), despite the fact that *zakāh* is deducted from their financial assets. This statistical proof invariably confirms the Qur'ānic claim[15] that prosperity will be the result of refraining from interest-based practices and promoting charities in society. We have already shown in the preceding sub-section that private saving and investment increases with the introduction of profit-sharing schemes in financial transactions and the enforcement of *zakāh* as an instrument of redistribution. These results categorically reject the apparent frustration of some quarters in this regard.[16]

5.2.2.2 Effects on consumption

The level of spending on general commodities may also be a fair candidate for the assessment of household welfare. The consumption expenditure of households changes following a change in public policies. The projected figures available by the end of the planning periods reveal the following picture. All the figures are expressed in Rupees per annum.

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[15] Please refer to the Qur'ān (2:276) which states that *"Allah condemns* ribā *(interest) and flourishes* ṣadaqāt *(charities, alms) and He doesn't like those who are ungrateful and wicked."*

[16] Please refer to the Qur'ān (2:268) which states that the Devil threatens you with poverty and ordains you to lewdness/obscenity, and (in contrast) Allah promises you forgiveness from Himself and bounty/prosperity (should you follow His commands).

Table 3.3: Effects on Household Consumption

Plan	Period	Consumption Expenditure per Household			
		Group 1	Group 2	Group 3	Group 4
Status quo	Base year End year (% change)	21068 25178 (19.508)	38115 45235 (18.680)	58335 112049 (92.078)	108317 370727 (242.261)
Zakāh only	End year (% change)	25915 (23.006)	47026 (23.379)	109452 (87.626)	422867 (290.397)
Profit-sharing only	Base year End year (% change)	21068 25178 (19.508)	39874 48301 (21.134)	61423 125152 (103.754)	105160 343535 (226.678)
Full scale system	End year (% change)	26272 (24.701)	49237 (23.481)	119405 (94.398)	400395 (280.748)

The increase in consumption of low-income households (Groups 1 and 2) by the end of Plans 2 and 4 is easy to understand. A slight reduction in consumption level of the higher-middle income class (Group 3) by the end of Plan 2 as compared to Plan 1 reveals the fact that their financial assets reach a level where *zakāh* becomes admissible and eventually both their income and consumption levels fall.

However, with introduction of the profit-sharing scheme, they are compensated and their position improves considerably as is evident from the results of Plans 3 and 4. Interestingly enough, the expenditure level of the high-income group improves in all the three revised cases as compared to the original case (*status quo*). Figure 3.2 illustrates the comparative position.

Figure 3.2(a): Income and Consumption Patterns (Rs. per annum)

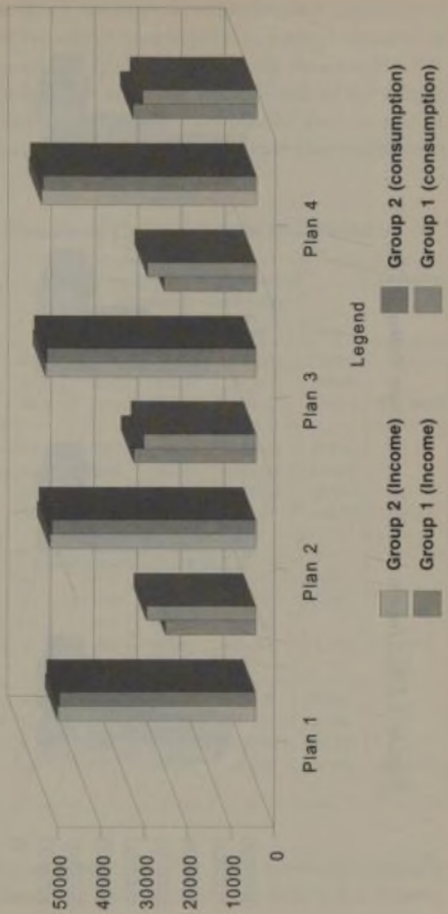
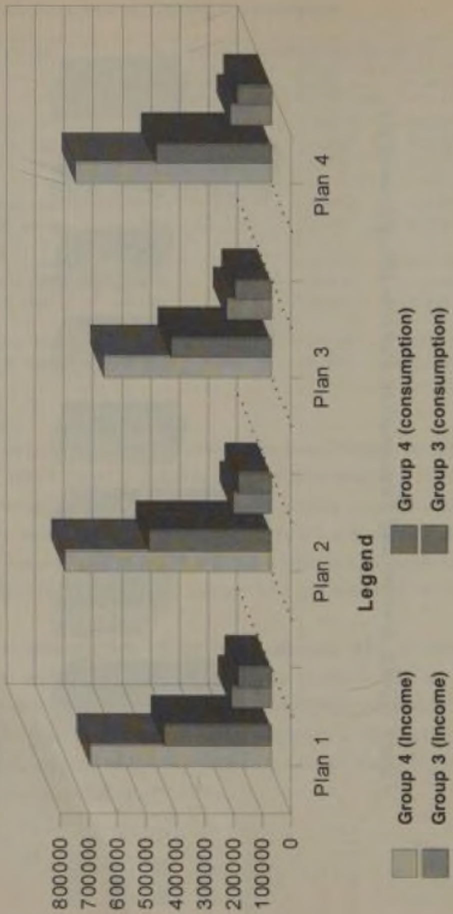


Figure 3.2(b): Income and Consumption Patterns (Rs. per annum)



In addition to the above, we may use a simple index composed of the real value of the household consumption as a rough measure of welfare to facilitate comparison among different policies. For this purpose, we may deflate the aggregate expenditures of the groups concerned for the end year of the relevant plan by the true cost of living indices (P_0), to get the present value. The inter-plan comparison is shown below:

Table 3.4: Household Consumption in Real Terms

Plan	Period End year position		Consumption Expenditure of Households (Real Value)				Remarks
			Group 1	Group 2	Group 3	Group 4	
Status quo	Per household	Rs.	25178	45235	112049	370727	
	Aggregate	Rs.m	177160	288834	2923011	360495	
	Real value	Rs.m	171845	280201	283327	349876	Ref. point
Zakāh only	Per household	Rs.	25915	47026	109452	422867	
	Aggregate	Rs.m	182346	300270	285243	411196	
	Real value	Rs.m	171560	282575	268518	387315	
	(change)	%	-0.165	+0.847	-5.227	+10.700	Over ref. point
Profit - sharing	Per household	Rs.	25178	48301	125152	343535	
	Aggregate	Rs.m	177160	398411	326158	343053	
	Real value	Rs.m	173931	302810	320264		
	(change)	%	+1.214	+8.069	+13.037	-3.705	Over ref. point
Full scale system	Per household	Rs.	26272	49237	119405	400395	
	Aggregate	Rs.m	184857	314388	311181	389344	
	Real value	Rs.m	179965	306100	303018	379225	
	(change)	%	+4.725	+9.243	+6.950	+8.388	Over ref. point

The above results are quite interesting. Poor households naturally gain from the introduction of a full scale Islamic distribution scheme.

The lower-middle income group is also much better off under this plan. The higher middle-income group loses a little under the second plan due to the enforcement of *zakāh* but gains much more under the third plan due to the eradication of the exploitative interest-based system. Another interesting feature to note is that the rich are hurt only by losing the privileged position they enjoy in the interest-based system and not by the payment of *zakāh*. This is evident from the results of Plans 3 and 4. Therefore the class concerned may try its best to maintain the status quo; in other words, it may resist any change that disturbs their status in society. However, such a reaction would be misleading. On close examination of the results, one can visualise the reality that this class, i.e. the rich would definitely reap the benefits of a full scale Islamic system along with the masses.

5.2.2.3 Effects on utility levels

The most popular measures of welfare effects used in the literature are the Compensating and Equivalent Variations (due to Hicks). Households may benefit or lose due to price and income changes following a policy change. The present model projects all the necessary information in this regard under different policy options. The money metric utility, i.e. the indirect utility function expressed in nominal terms, and the true cost of living index are computed for the base and end years from which we calculate the equivalent variations for different household groups. The symbols P_o, V_h and EV denote the true cost of living index in the base year, the indirect (money metric) utility and the equivalent variations respectively for the household groups concerned. The EVs for the household group concerned are calculated according to the relation:

$$EV_h = [\ V_h(\text{end}) - V_h\ (\text{base})\ ] * P_o \qquad (19)$$

The results of simulations for the four Plans are summarised below:

Table 3.5: Effects on Utility Levels

Plan	Period	Utility Index	Welfare measures for Households				Remarks
			Group 1	Group 2	Group 3	Group 4	
Status quo	Base year	P_o	5.5106	5.9279	6.4218	7.3437	
		V_h	3823.15	6429.69	9083.89	14750.00	
	End year	V_h	4710.34	7865.85	17983.05	55014.66	
		EV	4888.95	8513.41	57148.62	273660.48	Ref. point
Zakāh only	Base year	P_o	5.5106	5.9279	6.4218	7.3437	
		V_h	3823.15	6429.69	9083.89	14750.00	
	End year	V_h	4998.32	8429.71	18105.44	61133.05	
		EV	6475.89	11855.92	57934.59	340623.20	
	% change	→	32.46	39.26	1.37	24.47	Over ref. point
Profit sharing	Base year	P_o	5.7214	6.1538	6.6652	7.6193	
		V_h	3682.33	6479.64	9215.46	13801.72	
	End year	V_h	4482.43	7994.24	19122.49	45909.23	
		EV	4577.69	9320.54	66032.33	244636.75	
	% change	→	-6.37	9.48	15.54	-10.60	Over ref. point
Full scale system	Base year	P_o	5.7214	6.1538	6.6652	7.6193	
		V_h	3682.33	6479.64	9215.46	13802.72	
	End year	V_h	4716.70	8217.79	18397.30	53952.00	
		EV	5818.04	10696.23	61198.80	305917.03	
	% change	→	21.05	25.64	7.08	11.79	Over ref. point

The above statistics convey the message that there is a welfare gain for poor households in all the alternative plans as compared to the *status quo* except Plan 3, in which case they do not own any

funds for investment. Both the middle-income groups are better off under the three alternative plans. The high-income group is specifically hurt under Plan 3 due to their forgone position of preferential treatment in the interest-based financial mechanism that is now replaced by the more equitable profit-sharing system. Their welfare gain is positive under Plans 2 and 4, even after the deduction of *zakāh* from their assets. Apparently, this result seems contrary to conventional wisdom but as we have pointed out earlier, the enforcement of *zakāh* not only redistributes resources but also stimulates investment through a multiplier effect of enhanced consumption and the well-to-do class can reap its benefits more than proportionately. In the final analysis, however, the poor households benefit the most from the full-scale Islamisation schedule and nobody else is hurt at all. This is a very strong proof of Pareato-improvement as evident from the percentage change of equivalent variations in the relevant plan over the status quo.

5.2.3 *Income Distribution and Poverty Profile*

The social impact of various alternative policy regimes can be judged in different manners. Here we study the effects of perspective plans on the income distribution across households and on the state of poverty.

5.2.3.1 Effects on income distribution

The most commonly used indicator in this regard is the Gini coefficient which measures the area falling between the line of equality (representing the ideal distribution) and the Lorenz curve (representing the actual distribution) if cumulative income shares are measured along the vertical axis and population shares along the horizontal axis. We refer back to the observed data for the base year (1989-90) for which the value of the Gini coefficient has been

calculated as: G = 0.378095.[17] However, on the basis of information projected by our model in the benchmark equilibrium, the index is calculated as under. As evident from calculations, the coefficients for the observed and projected data in the base year are comparable.

Table 3.6: Calculation of Gini Coefficient

Class	Income shares	Cumulative Shares (Z_i)	$(Z_i + Z_{i-1})$ with $(Z_0 = 0)$	Population Shares	$P_i(Z_i + Z_{i-1})$
Low income group	0.169850	0.169850	0.169850	0.4139	0.070301
Lower-middle income	0.333266	0.506116	0.675966	0.3756	0.253893
Higher-middle income	0.250102	0.765218	1.262334	0.1533	0.193516
High income group	0.243782	1.000000	1.756218	0.0572	0.093606

The Gini Coefficient is given by: $G = 1 - \Gamma P_i (Z_i + Z_{i-1}) = 1 - 0.611315 = 0.388685$ for the base year.

Next, we compute the index for the final years of simulation under the four plans and compare the results.

Table 3.7: Income Shares by the End of Perspective Plans and Gini Coefficients

Class	Plan 1	Plan 2	Plan 3	Plan 4	Base Year
Low income group	0.105041	0.129176	0.105998	0.129963	0.169850
Lower-middle income	0.208496	0.197317	0.219404	0.204538	0.336266
Higher-middle income	0.250915	0.222588	0.276308	0.241066	0.250102
High income group	0.435548	0.450919	0.398290	0.424433	0.243782
Gini Coefficient	0.575225	0.552553	0.560950	0.542120	0.388685

[17] We are thankful to Zubair Hasan for pointing out an error in the calculation of the Gini coefficient in the original document. The corrections have been made accordingly.

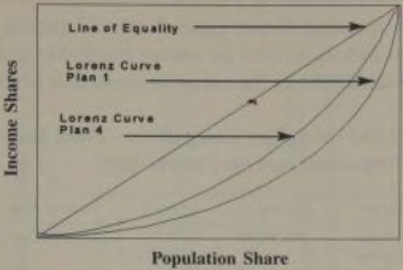
The above results reveal a deteriorated situation. Income distribution worsens further if the existing system (Plan 1) prevails for a decade. The factual position on the ground as well as the official statistics support this result, i.e. the poor are becoming poorer and the rich becoming still richer. So far as the alternative plans are concerned, even there the results are not encouraging when compared to the base year. This is because the time span of ten years seems too short to solve the problem of acute inequality. However, the 2nd and 3rd Plans individually record an improvement in the distribution (to the extent of 3.94 percent and 2.58 percent respectively) as compared to the final position of Plan 1. On the other hand, the situation regarding income inequalities is somewhat improved under the 4th Plan. The improvement in the coefficient (about 5.75 percent) indicates that inequalities in distribution would be speedily reduced under this plan. Ambitious results cannot be expected within a few years, however.

There is though, one problem with the Gini coefficient recognised in the literature. Should the Lorenz curves under two or more than two distribution schemes intersect one another, then the comparison becomes meaningless. To see whether the curves intersect one another, we may compare the cumulative income shares of the respective groups under different plans as follows:

Table 3.8: Cumulative Income Shares Under Different Plans

Income Shares Cumulative	Plan 1	Plan 2	Plan 3	Plan 4	Population Shares Cumulative
Low income group	10.50	12.92	10.60	12.99	41.39
Lower-middle income	31.35	32.65	32.54	33.45	78.95
Higher-middle income	56.44	54.91	60.17	57.55	94.28
High income group	100	100	100	100	100

Figure 3.3: Status of Income Inequality by the end of Plans 1 and 4



Status of Income Inequality by end of Plans 1 and 4.

As noted earlier, our point of reference is Plan 1. It is now evident that meaningful comparison is possible between Plan 1 versus 3 and Plan 1 versus 4. The cumulative income shares of respective groups under both Plan 3 and 4 are continuously higher than those under Plan 1. Thus, income distribution under these plans is comparable (and better as shown above) with the reference plan. The factual position is depicted in Figure 3 that renders the comparison clearer.[18]

5.2.3.2 Effects on poverty states

The two phenomena of mass poverty and inter-class income disparities are closely related. They coexist and reinforce each other such that one cannot be treated in isolation of the other. A good measure,

[18] An observation was raised during discussion that aggregation of households into just four (4) income groups leads to a considerable loss of area between the line of equality and the Lorenz curve, measured by the Gini coefficient. To verify the fact, we calculate the coefficient for the original eleven (11) groups considered in HIES 1990-91, using the observed data for the base year. On the basis of that information, the value of the coefficient turns out to be G = 0.404649. The loss in area on account of aggregation is, therefore, in the range of 6-7 percent, which may not be taken as serious. In particular, when we compare inequalities under different policy options, the question of aggregation tends to be the least significant.

which is useful for our analysis, is to estimate the deviation of the disposable income of various groups from the poverty line. As mentioned earlier, the poverty line assumed for the base year amounts to Rs.21,068 at 1989-90 prices. We have assumed a growth rate of 2 percent for the poverty line in our analysis. As such the amount required to finance the basic needs will be Rs.25682 by the end of the simulation period.

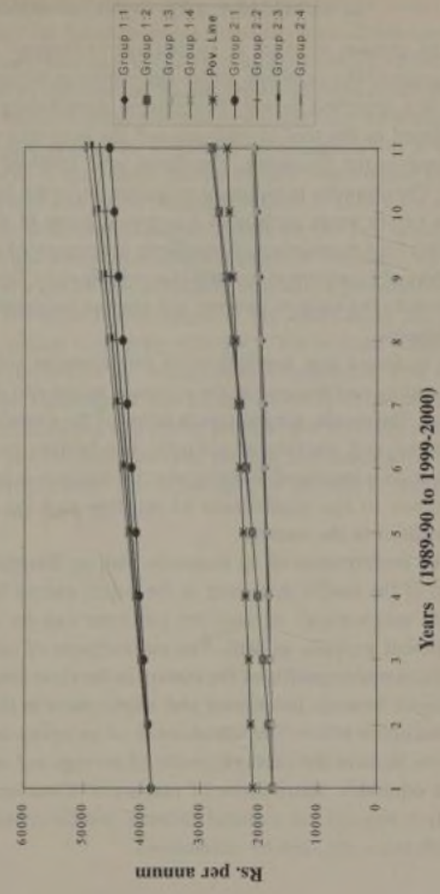
Table 3.9: The Inter-Plan Comparison - Final Year Projections and the Poverty State.

Item (Disposable Income)	Group 1	Group 2	Poverty Line
Base Year – Actual Income Deviation from Poverty line	Rs.16996 -4072	Rs.36712 21641	Rs.21068 per annum
Final Year – Projected			Rs.25682 per annum
Plan 1 – End Year Income Deviation from Poverty line	Rs.20811 -4871	Rs.45520 19838	Reference point
Plan 2 – End Year Income Deviation from Poverty line Improvement over Ref. point	Rs.28173 +2491 51.13 %	Rs.47323 21641 9.09 %	
Plan 3 – End Year Income Deviation from Poverty line Improvement over Ref. Point	Rs.21310 -4372 10.24 %	Rs.48607 22925 15.56 %	
Plan 4 – End Year Income Deviation from Poverty line Improvement over Ref. point	Rs.28570 +2888 59.29 %	Rs.49549 23867 20.31 %	Better performance

We compare the projected disposable incomes of the poor and lower-income groups with the poverty line and see the deviation under various schemes. All the figures are expressed in Rupees per annum for the household concerned.

The above statistics indicate that the position of poor households is considerably improved by the end of Plan 2 and 4 on account of *zakāh* administration. The transfers enable them to raise their living standards. Similarly the position of the lower-income group improves under Plans 3 and 4 on account of receiving due share in their investment. The position is shown in Figure 3.3.

Figure 3.4: Poverty State Groups 1 and 2 under Perspective Plans



6. SUMMARY AND CONCLUSIONS

The present exercise is an attempt to forecast the *would-be scenarios* of the economy under alternative policy regimes by the end of a specified period. The general equilibrium framework is employed as the tool of analysis and the economy of Pakistan is selected as the specimen. The fiscal year 1989-90 serves as the base. The economy is supposed to operate under the four prospective plans of ten years each with a common point of departure. The results of the counterfactual equilibria are compared and contrasted in terms of important micro and macro indicators. Special attention is given to the state of poverty and income inequalities across the households.

It is found that the full-scale Islamisation scheme ensures outstanding performance of the economy by the end of the planning period. The results are positive in terms of the overall profile of the economy and welfare of society. The budget position of the Federation is improved. In particular, the analysis is persuasive with reference to the eradication of poverty and the reduction of inequalities in the society.

The performance of an economy with an Islamic character, in terms of the results discussed in the paper, cannot be regarded as barely mechanical; in fact the outcome can be supported on theoretical grounds as well. The enforcement of *zakāh* enhances the consumption profile of the masses in the short-run, which raises aggregate demand, investment and employment in the long run via the multiplier effect. The introduction of an equity-based financial scheme leads to the encouragement of savings and investment and to an equitable distribution of resources. Consequently, all the positive impacts on national income, public revenues, sectoral growth rates, etc., can be rationalised.

The study does not claim that the introduction of *zakāh* as a fiscal instrument for redistribution and the abolition of interest from financial transactions are the only requirements of an Islamic system. Likewise, the contention, that the adoption of *zakāh* and an equity-based business profile would open gateways to prosperity and solve all the problems, would be an exaggeration. What is emphasised here is that there cannot be any compromise on the prohibition of *ribā* and on the obligatory status of *zakāh*, for which an Islamic state is held responsible. Therefore, the two areas have attracted particular attention in Islamic economic literature. We have simply tried to explore the economic incentives associated with fulfilment of the least requirements of the Sharī'ah in the areas where public policy is directly relevant. This is done within the methodology followed by mainstream economics. The study establishes the viability of the Islamic system of finance and distribution on efficiency and equity grounds and logically presents a strong case for the initiation and prompt implementation of an Islamisation programme. This is the need of the time to reduce the grievances of the poor masses.

Summary Table 3.10(a): Effect of Alternative Policies on the Economy (Macro-economic Indicators)

Variable	Indicator	Plan 1 Status quo	Plan 2 *zakāh* only	Plan 3 Profit-sharing only	Plan 4 Full scale system	Remarks (Plan duration 10 yrs)
Gross Revenues	Growth rate	0.0809	0.0930	0.0781	0.0904	Modest& efficient 4th plan
Tax Revenues	- do -	0.0849	0.0992	0.0813	0.0954	- do -
Current Pub. Expend.	- do -	0.0713	0.0834	0.0694	0.0809	- do -
Public Consumption	- do -	0.0718	0.0836	0.0699	0.0811	- do -
Development Budget	- do -	0.1270	0.1541	0.1211	0.1484	- do -
Private Consumption	- do -	0.0599	0.0615	0.0559	0.0607	- do -
Private Saving	- do -	0.1270	0.1541	0.1211	0.1484	- do -
Fixed Investment	- do -	0.1299	0.1600	0.1228	0.1510	- do -
Exports /Imports	- do -	0.0890	0.1062	0.0858	0.1027	- do -
GDP (mp)	- do -	0.0701	0.0813	0.0685	0.0791	- do -
Value Added (fc)	- do -	0.0697	0.0807	0.0679	0.0782	- do -
Agriculture*	Share in VA	-2.96	-3.77	-2.67	-3.54	- do -
Manufacturing*	- do -	+0.98	+1.34	+0.97	+1.35	- do -
Services*	- do -	-0.23	-0.53	-0.35	-0.68	- do -
Fiscal deficit position	Turning point	9th year	7th year	7th year	5th year	Speediest 4th plan
External debt outstanding	Growth rate	0.0912	0.1072	0.0892	0.1045	Slowest 3rd plan
Internal debt outstanding	- do -	0.0123	0.0089	0.0059	0.0035	Slowest 4th plan

* Indicate changes in sectoral shares in the VA, expressed in percentage points during the plan period.

Summary Table 3.10(b): Effect of Alternative Policies on the Economy (Micro-economic Indicators)

Variable		Indicator	Plan 1 Status quo		Plan 2 *Zakāh* only		Plan 3 Profit-sharing only		Plan 4 Full scale system		Remarks
Gp1	Gp2	% change over base year	18.372	18.677	60.247	23.639	19.578	21.133	60.316	23.480	4th plan efficient.
Gp3 HH Disposable Income	Gp4		92.029	241.972	87.527	226.738	103.723	226.513	94.353	280.468	
Gp1	Gp2	- do -	19.508	18.680	23.006	23.379	19.508	21.134	24.701	23.481	4th plan mild but efficient.
Gp3 HH Consumption	Gp4		92.078	242.261	87.626	290.397	103.754	226.678	94.398	280.748	
Gp1	Gp2	% change over Plan 1 (status quo)	—	—	-0.166	0.847	1.214	8.069	4.725	9.243	- do -
Gp3 Real value of consumption	Gp4				-5.227	10.700	13.037	-3.705	6.950	8.388	
Gp1	Gp2	Equivalent variations % change over Plan 1	—	—	32.46	39.26	-6.37	9.48	21.05	25.64	4th plan mild but efficient.
Gp3 Welfare measures	Gp4				1.37	24.47	15.54	-10.60	7.08	11.79	
Income distribution		Gini coefficient by end of plan period	0.535179		0.506685		0.519424		0.495628		4th plan leads to equitable distribution
Gp1 Poverty state by end of plan period	Gp2	Deviation of disposable income from poverty Line (Rs)	-4871	19838	+2491	21641	-4372	22925	+2888	23867	4th plan better to reduce poverty.
Relative position of Capital to Labour		Relative shares (Π/1-Π) in functional distribution	2.008930		2.023870		1.973933		1.946350		4th plan labour friendly.

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Comments

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1. INTRODUCTION

Writers in the area of Islamic economics have often sought to demonstrate that the replacement of interest by profit-sharing in business finance plus the introduction of *zakāh* as a redistributive measure are the sure means to alleviate poverty and improve income distribution.[19] The paper under discussion essentially is in the same vein but with a difference. Unlike the earlier writings, Yasin and Tahir do not rely purely on *a priori* reasoning. Rather, they attempt at building a concrete empirical case to demonstrate how effective, rather miraculous, the two measures could be, if put into operation. In that, their effort is laudable. The authors seek to prove their point by building what they call a computable general equilibrium (CGE) model for the economy of Pakistan. They choose and adjust the data for the 1989-90 fiscal year to serve as the base for their work.

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[19] The literature review in the paper leaves out several important contributions, one for example being that of Munawar Iqbal (1985), "*Zakāh*, Moderation and Aggregate Consumption in an Islamic Economy", *JRIE*, Vol. 3, No. 1.

The authors take the factors of production as grouped into two broad categories: labour and capital. The supply side consists of commodity producing sectors at home including public services plus the external transactions, while the demand side comprises households, the government and investment sectors. The parameters for the model are mainly obtained from the available literature, but a few have also been *calibrated.* After carefully specifying the model which includes functions concerning production relations, consumer behaviour, income generation, and income distribution in a secular setting, the authors also mention their Islamic variants, bringing in *zakāh*, and the interest-free financing of business.

To unfold the Islamic ramifications of their construct, the authors start with the situation on various fronts in the Pakistan economy in 1989-1990 to serve as the benchmark, and present the results of four policy alternatives, each with a time span of ten years, for the purposes of comparison: the three plans with Islamic elements are shown as superior to the first, the secular one, in terms of results. The fourth plan is found to be the best for alleviating poverty and improving distribution. The paper's argument is based on some well spelled out assumptions, the crucial one being that the Cobb-Douglas function homogeneous of degree 1 applies both in production and consumption.

It is difficult to cover in the present review the numerous aspects of the authors' wide ranging thesis, more so its mathematical formulations. So, we have chosen to discuss here, briefly, a few matters concerning the data adjustment procedures, Islamic variables for Plans 2, 3 and 4, comparative results, and conclusions.

2. DATA ADJUSTMENTS

The authors have utilised three sources of information on a selective basis for obtaining an integrated and internally consistent data set on relevant macro-economic variables for 1989-90, the point of departure for their alternative policy plans. These include the

Household Income and Expenditure Surveys (HIES) for the years 1987-88 and 1990-91 as well as the National Accounts figures. The key figure around which all adjustments revolve is the aggregate disposable income fixed at Rs.695282 million for the year. Save for some discrepancies, the adjustments are in order. But there is one difficulty. The exercise uses in this connection the Consumer Price Index (112.7) for deflating the 1990-91 sources of income data for the economy as given in the HIES of that year to achieve the corresponding figures for 1989-1990. Now, the factor reversal test in the theory of index numbers informs us that the product of price and quantity indices must equal the value index. In symbols we have:

$$P_{01} \cdot Q_{01} = V_{01} \quad \text{where } V_{01} = \Sigma\, p_1 q_1 / \Sigma\, p_0 q_0$$

Suppose $\Sigma\, p_0\, q_0$ is the GDP for 1989-90 and $\Sigma\, p_1\, q_1$ for 1990-91. Then, to obtain the former we have to divide $\Sigma\, p_1 q_1$ not by the price index P_{01} alone but also by the quantity index Q_{01}. Otherwise, we merely get the figures for 1990-91 at constant prices with reference to the base of the deflator, i.e. 1989-90 = 100. Alternatively, there is an implicit assumption that the quantity Q of goods and services has registered no change in 1990-91 compared to 1989-90 *item by item* and the *relative* prices have also remained unaltered. We are not sure if the authors considered the implications of this fact for their results.

Interestingly, despite this cumbersome adjustment exercise, the data as one finds them in the Appendices and the text are not mutually compatible. To illustrate, compare the initial configuration of figures after adjustment[20] for the base year 1989-90 with the one that emerges from Table 3.1.

[20] The figures in Table 3.11 have been obtained by dividing the figures in Table 3.1 by the corresponding number of households in each group. Other necessary adjustments have been made.

Table 3.11: Yearly Allocation of Income

Item	Per Household (Rs.)		Aggregate (Rs. million)	
	Initial	Table 3.1	Initial	Table 3.1
Gross income	41105	43868	698777	745721
Direct taxes paid	206	206	3495	3495
Disposable income	40899	43662	695282	742226
Consumption	36806	38174	625700	648966
Savings	4093	5488	69581	93260

Thus the disposable income, the centrepiece of the adjustment process, does not hold its own. Furthermore, it stands differently at Rs.42842 per household with an aggregate of Rs.728320 million when calculated from the figures given in Table 3.2. Additionally, these figures in the text do not reconcile well with those given in the extra information sheets provided to the discussant. These discrepancies are not small, and may put in jeopardy the results drawn from the data.

3. ISLAMIC VARIABLES

For introducing *zakāh* in Plans 2 and 4, the authors calculate its amount at 2.5 percent on gross wealth or capital assets owned by the households at the end of the accounting period with *niṣāb* or the exemption limit fixed at Rs.15000 for the base year on the basis of a gold value equivalent. This raises a few queries: how is the value of capital assets calculated, what was it for the base year, and how did it grow over the period? One finds no clue in the paper. Neither do the results mention any amount separately nor is there any variable in the distribution equations incorporating *zakāh*. One possible way to know the role of *zakāh* in the study is to estimate, and compare the expenditure (consumption) of the first group in each year for Plan 2 with that of Plan 1. This can be done by taking the beginning and end period expenditure per household in each

case, estimating the growth rates, and using them to develop the respective series. The difference in these series would give us for each year an estimate of *zakāh* support to the disposable income of the group, assuming that the other transfer payments continue to play their proportionate role.[21] For the two Plans, these rates are found to be 1.8 percent and 2.1 percent respectively. The results of the exercise are produced in Table 3.12 below.

Table 3.12: Estimation of* Zakāh *Support for Group 1 Expenditure (Rs.)

Year	Values for Plan 2	Values for Plan 1	*Zakāh* Component
Initial	21068	21068	—
1	21510	21447	63
2	21962	21833	129
3	22423	22226	197
4	22894	22626	268
5	23375	23034	341
6	23866	23448	418
7	24367	23870	497
8	24878	24230	648
9	25401	24737	664
10	25935	25182	753

These estimates seem to be in order. Due to *zakāh* receipts, the mean expenditure of the households crosses the poverty line, advancing at 2 percent per year, at the same time point in the above Table as in Figure 3.4 of the paper. Interestingly, the *zakāh* payments as a proportion of the household expenditure (Plan 2) grow each year by about 0.29 percent. Perhaps an explanation for the phenomenon is needed. Furthermore, the aggregate *zakāh* payments to the group approximate to Rs.443 million in the first year of Plan 2. Capitalised at 2.5 percent, the assets subject to *zakāt* should be worth about

[21] This is because transfers/debts form an entry in disposal of income.

Rs.18000 million. The paper does not provide any information on what is included in the capital assets chargeable to *zakāh*. At some places it equates them with wealth and at others with the financial assets of the households.

A little reflection would show that the household classification scheme of the paper is not very appropriate for the study of the impact of *zakāh* on society. Notice that the classification into groups is with reference to income, not according to *niṣāb*: the average initial disposable income of the households in Group 1 at Rs.17581 is much higher than the exemption limit of capital assets at Rs.15000 for attracting the *zakāh* levy. However, since this group is taken to be entirely consisting of *zakāh* recipients, the position of the households it includes is clear on the question of *niṣāb*. But what about the remaining three groups: their high *average* incomes in no way prove that *all* their members have assets above *niṣāb*, or none of them is or would be entitled to receive *zakāh*. In other words, among the households in the three groups, one may expect quite a number of households having assets below *niṣāb*, or incomes low enough to qualify for *zakāh* support. Presumably, for the study of the *zakāh* issue, a division of the households on the basis of *niṣāb* would have given better results. Alternatively, the authors could have made the position clearer by providing details of the incoming and outgoing revenue flows over the years from what they name as the *zakāh* fund for the exercise.

Again, for the economy as a whole the authors mention a fixed rate of interest 'r*' and a profit rate 'r' both determined by the market. They also tie the two in a sort of difference relationship (equation 16). But they skip the crucial question, i.e. how the sharing of the profit ratio for the outside financier is determined under an interest-free system. In their scheme, firms and financial institutions are kept out of the picture: investment made and profit received are both treated as exogenously given components of the household account. As such, the sharing ratio determination and the related issues of adverse

selection and moral hazard become inconsequential. However, even the value of 'r' the authors have used to arrive at their calculations under Plan 3 is not available. But there is, perhaps, a clue to unfold what the replacement of interest by profit-sharing has achieved in the authors' scheme. Table 3.2 of the paper provides for the base year two alternative sets of values for the disposable income per household *albeit* without giving a reason. These sets are produced below for ready reference along with some other information needed for the following discussion.

Table 3.13: Disposable Income per Household (Rs.)

	Group 1	**Group 2**	**Group 3**	**Group 4**	**Weighted Mean**
Base Year Values A	17581	38356	69895	182591	42842
Base Year Values B	17821	40127	73619	171452	43884
End Period Values:					
Plan 1: Status quo	20811	45520	134219	624411	83211
Plan 3: Profit-sharing	21310	48607	149979	579405	82003
Million of Households	7.0363	6.3852	2.6061	0.9724	

Set A of base year disposable incomes includes net interest receipts by the households and has obviously been used to arrive at the Plan 1 end period results. Set B of base year values seems to be an adjusted version of set A, i.e. shorn of interest. For, the profit-sharing scheme becomes operative from the very beginning of the year. The aggregate income for set A is Rs.728320 million. For set B, it works out at Rs.746025 million. Why are the two aggregates different? It clearly is the deletion of interest payments from the gross household income to the extent of Rs.17705 million which has raised the aggregate disposable incomes in set B. Implicit in that is a net flow of interest payments from the household sector to outsiders, government and/ or financial institutions. That apart, the amount of interest payment

per household in the base year was about Rs.1042 (= 43884 - 42842). The difference of the end period weighted means for Plans 1 and 3 at Rs.1208 is just Rs.166 more than the interest equivalent used to adjust the base year figures. This certainly is not a very elating improvement.

That the results of Plan 3 would not cause much elation was indeed ensured by the constraints of the choice of general equilibrium instrument for analysis imposed on the authors' model. Because such analysis requires that the equilibrium of the household, and equilibrium in the markets for final goods are consistent with equilibrium for the firm, and equilibrium in the factor markets, it had to rest on the assumption of perfect competition as a feasibility condition. In fact, the authors do cast their analysis in a framework of competitive conditions, and constant return to scales with transactors in the markets having no pricing power. Interest rate r^*, and r, the long run rate of profit, which must now only be normal, could hardly differ. For this reason, classical writers did not bother much about the distinction between interest and profit. The model under review provides empirical evidence on the point. It implicitly demonstrates that the division of a firm's value product between labour and capital as apportioned by the marginal products of factors is *just* as well on the contribution criterion. It is time for economists to realise that no other idea has done more harm to the cause of distributive justice than the attempt at isolating on this basis the contribution of an individual factor in a firm's value product under *real* world situations.[22] Also, one must not forget that no effort at ensuring equity in personal income distribution would ever succeed without ensuring at the same time equity in functional income distribution. The constructors of the present model seem oblivious to this important fact.

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[22] For a fuller argument on the point see Zubair Hasan's Review of M.N. Siddiqi's book *Teaching Economics in Islamic Perspective*, Section 5, *Islamic Economic Studies*, Vol. 6, No.1 (1998).

4. THE RESULTS

Here we shall not go over the larger gains that the authors claim accrue in terms of growth, prosperity and welfare improvement under the alternative Islamic plans compared with the secular one, save one cursory observation. They did not find profit-sharing alone (Plan 3) of much consequence. So, the large improvement in results under Plan 4 is mainly because of introducing *zakāh* in the model as an additional factor. The authors rightly point out that "*zakāh* not only redistributes resources but also stimulates investment through the multiplier effect of enhanced consumption." Now, religious reverence for *zakāh* apart, in cold logic why must its effects be different on growth and welfare from other egalitarian transfers in modern economies? In fact, the volume of such transfers is much larger in the Western world if only because the rich can afford to be more benevolent. Mainstream economics just does not include them in their theoretical models or empirical exercises to analyse their impact on progress and prosperity. Presumably, too much reliance is being placed on *zakāh* as a panacea for economic ills by Islamic scholars; more so in a country where people are up in revolt against filing the simple tax survey forms.

However, let us turn to the performance of the Islamic models of the authors with reference to the main objectives of the paper: reduction in the inequalities of incomes, and the amelioration of poverty. The evaluation of the authors' results on these counts must be prefaced with a reference to an important aspect of their work. Their model takes the household, not the individual, as the unit for analysis. The average size of the unit consists of 6.5 individuals. Over the ten year time span of the plans the number of the household units is kept unchanged at 17 million. At the same time, the population of the country is deemed to increase by 2.5 percent each year. This means that not only would the number of households increase to around 22 million by the end of the decade, their composition and

structure within and between the four groups may also change. Alternatively, if the number of the households is kept constant, as the authors envisage, the average size of the household unit must rise to over 8.3 persons. The changes in the household size or number could be of far reaching consequence for the state of poverty and income/asset distribution in society. The results of an analysis, which ignores this reality, can hardly be taken at their face value.

However, let us consider the claims of the authors within their own framework The impact of the Islamic measures on poverty is examined through their beneficial effects on income and utility levels of the lower groups, especially the first. Let us compare the positions of the first and fourth groups under Plans 1 and 4. The data used below are taken from Table 3.2 of the paper.

Table 3.14: Comparison of Disposable Incomes of Groups Under Different Plans (Rs.)

	Group 1 I	Group 4 II	Absolute Difference III
End of Plan 1	20811	624411	603600
End of Plan 4	28570	675148	646578
% increase	37.28	8.13	7.12

By the end of the period, the income of the average household increased under the (best) Islamic plan more than under the secular arrangement for both the poor and the rich. Also, the increase has been larger proportionately for the former. Still, *relative* poverty has increased – the rich becoming richer, the poor becoming poorer as column 3 of the table reveals. The authors do recognise this fact with reference to the base year but not when comparisons are made with Plan 1 figures. Even the rise in the consumption expenditure of Group 1 households and their ability to cross the poverty line is not because of any worthwhile increase in their productive power. It has depended essentially on increasing *zakāh* support. The authors do seem to

concede the point when they say: "The transfers enable them (the poor) to raise their living standards."

Next, consider the estimation of the effects of alternative plans on the utility levels of the households. For this purpose the authors combine three variables: the *true* cost of living index in the base year P_0, the indirect utility, i.e. measured in nominal money V_h and the equivalent variation EV. The difference of the end and beginning period utility V_h, is multiplied by the index P_0 to obtain the EV. Based on the EV values so calculated, it is claimed that there is a welfare gain in the Islamic Plans 2 and 4 compared to the status quo Plan 1. Intuitively, the claim appears to be true but sufficient information is not available for its verification. Utility is a subjective phenomenon, and all attempts at its quantification have an element of arbitrariness. The objective element in the calculations is P_0. But even here despite clarity at the theoretical level about a true cost of living index, arriving at one in practice is rarely possible. Here we do not have the data to construct a cost of living index, true or otherwise. P_0 has no independent existence: it is derived from the indirect utility function V_h. Putting the two in a formula for estimating EV is, therefore, somewhat dubious. It is appropriate to note that a *true* cost of living index must be independent of the reference utility level. It is unique only in the homothetic case where it has a double limit, i.e. $P^P_{01} \leq P_{01} \leq P^L_{01}$.[23] Admittedly, it is not possible to meet the requirement of homotheticity, i.e. the consumer spends the same proportion of his total income on each commodity irrespective of its level. But this very fact does warn that empirical results based on quantifying utility can only be taken with a pinch of salt. Thus, the paper does not seem to cut much ice on the poverty alleviation front.

The position is no different in the case of income distribution. Table 3.14 has already thrown some light on the issue. To prove that under Islamic dispensation income distribution would improve, the

[23] See Nagar and Das (1988), *Basic Statistics*, Delhi: Oxford University Press, pp.304-305.

authors construct comparative Lorenz curves and calculate Gini coefficients for the base year and the alternative plans. As *zakāh* transfers purchasing power from the rich to the poor, some improvement in the distribution of incomes is obviously expected. The contribution of the paper is to be examined in the way the authors chose to demonstrate the fact.

The Table below provides the cumulative population shares which in the scheme of the paper remain fixed for the projection decade and the corresponding income shares calculated from the data for the base year, Plan 1, and Plan 4.

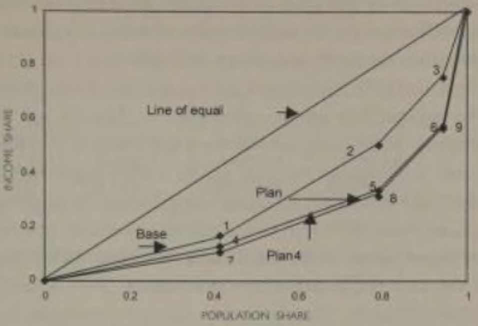
Table 3.15: Cumulative Population and Income Shares

Population Shares	Income Shares and Coordinate Points					
	Base	Points	Plan 1	Points	Plan 4	Points
.000000	.000000		.000000		.000000	
.413900	.169850	1	.105041	4	.129863	7
.789500	.506116	2	.313537	5	.334501	8
.942800	.756218	3	.564452	6	.575567	9
1.000000	1.000000		1.000000		1.000000	

The points for the three Lorenz curves are given in the following Figure. Here, we find that points 1, 2, and 3 are clearly above the rest showing that distribution of income deteriorated during the Plans under consideration.

Points 7, 8, and 9 for Plan 4 do lie respectively above points 4, 5, and 6 for Plan 1 showing better results for the former, i.e. the Islamic alternative, but the differences are too small: 0.024822, 0.020964, and 0.011115. They decrease as we move up from the lower towards the higher income groups showing that enhanced transfer payments to the poor because of *zakāh* enforcement make them better off. However, these facts put serious question marks on the shape of and the distance shown between the two Lorenz curves in the paper.

Figure 3.5: Chords of Lorenz Curves



The use and calculation of the Gini coefficient is also somewhat fuzzy. An important ingredient of the measurement is the area lying between the line of equal distribution and a given Lorenz curve. The calculation of this area uses the chords joining consecutive points on which the curve rests. The area between the chords and the curve is lost for the calculation of the coefficient. The constraint detracts from the accuracy of the measure. But the larger the number of values used to construct the curve, the greater the number of chords with smaller size, so less will be the area lost, and more accurate will be the Gini coefficient obtained. To have just four income groups for a population of 17 million households is perhaps too high a degree of approximation for arriving at reasonably reliable results.

In addition, the calculation of the coefficient is vitiated with a serious lapse in applying the formula, which is reproduced below for ready reference:

$$G = 1 - \sum_{i=1} p_i \, (z_i + z_{i-1}), z_0 = 0$$

Here, the term in brackets is the sum of consecutive z_i values, not their accumulation as one finds in the paper. To clarify the point we present below the two positions in the case of estimation for the base year. Values from the paper are shown in brackets.

Groups	1	2	3	4
z_i(cumulative)	0.169850	0.506116	0.756218	1.000000
z_i, z_{i-1}	0.169850	0.675966	1.262334	1.756218
	(0.169850)	(0.675966)	(1.432184)	(2.432184)

The corrected values of the coefficients are given below together with their values in the paper shown in brackets

	Base Year	Plan 1	Plan 2	Plan 3	Plan 4
Gini Coefficients	0.381834 (0.317131)	0.565223 (0.535179)	0.552398 (0.506685)	0.560346 (0.519424)	0.542118 (0.495628)

The differences between the two sets of values is not large as only four values are involved in the construction of the coefficient, and the first two values remain the same in both cases. Even so, the gap between the coefficients in the case of Plan 1 and Plan 4 has now narrowed down to an almost inconsequential level. Thus, on the distribution front too the paper has hardly achieved what it aimed at. The authors are simply apologetic in blaming the non-achievement because of the insufficiency of the time span, ten years, for the model to show the Islamisation effects in full. The fault lies elsewhere.

5. CONCLUDING REMARKS

The authors set out to prove some propositions in Islamic economics which scholars have intermittently attempted to do, i.e. the enforcement of *zakāh* and the replacement of interest-based

components of financing with profit-sharing in free market economies helps alleviate poverty, and mitigates the present inequalities in the distribution of income and wealth which are admittedly too agonising. The method used by the authors is novel, but novelty need not always be rewarding. General equilibrium analysis has to rest, of necessity, on the assumption of perfect competition.[24] This has put restraints on the authors' model to bring out the real significance of the Islamic measures, especially the consequences of interest-free financing. The superiority of Islamic measures can better be demonstrated in a framework of real world situations.[25] This is what Islamic economists have not yet been able to do conclusively, despite some brilliant efforts.

Zakāh payments enhance the magnitude of egalitarian income/wealth transfers and must have to that extent a relieving impact on the state of poverty, and distributive inequity in an economy. It is too obvious to be proved. The real strength of *zakāh* lies in the fact that its payment being a religious obligation, collection is likely to be larger and ensured as compared with usual charities or donations. The replacement of interest by profit-sharing could not show much promise in the authors' model for the reason we have already given. On the practical front the introduction of profit-sharing as an alternative has indeed made some promising headway, even with the mainstream financial institutions.

The weaknesses we have indicated above apart, the work under discussion retains all the institutions of the secular system intact

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[24] Notice that the model, despite having perfect competition moorings, only aggravates the initial income disparities, as the economy grows under any Plan choice – secular or Islamic. The implications of this phenomenon are worth investigating.

[25] For illustration see Zubair Hasan: "Profit Maximization – Secular Versus Islamic" in Sayyid Tahir et al. (ed.) (1992), *Readings in Microeconomics in Islamic Perspective*, Kuala Lumpur, Malaysia: Longman, pp. 248-251.

except that it deletes interest, and introduces *zakāh* into the picture. The authors also do not insist on any changes in the socio-economic state of the country. We believe that a change in the political power structures whereby they are more inclined to the promotion of Islamic norms of behaviour and the enforcement of religious injunctions is the first imperative for the success of any process towards Islamising the economies of Muslim countries, including Pakistan. The role of non-governmental organisations and socio-religious movements is also crucial in the matter. But interestingly, almost everything remains static in the authors' *dynamic* model, except the computer.

CHAPTER 4

Microfinancial Services and Poverty Alleviation in Bangladesh: A Comparative Analysis of Secular and Islamic NGOs

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and
*Dewan A.H. Alamgir***

1. INTRODUCTION

The purpose of this paper is to examine microfinancial services of Islamic Non-Governmental Organisations (NGOs), secular NGOs, government banks, private banks and government organisations by analysing secondary data collected from these organisations. To our knowledge, this is the first comparative analysis of a group of Islamic NGOs and secular NGOs in Bangladesh. The basic difference between a secular and an Islamic NGO is that the former follows an interest-based lending policy whereas the latter follows an interest-

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free but fee-based lending policy. Otherwise, both basically follow the group-based lending model of Grameen Bank with some modifications.

The paper examines the design of microfinancial services, reviews the publications related to microfinance institutions, and analyses programme data from respective organisations. We held discussions with key officials of the respective organisations, and analysed the financial reports of those institutions. The study improves upon existing studies on MFIs by analysing statistically their membership and savings information, disbursement and repayment record. Most importantly, the study compares the performance of secular and Islamic NGOs, private and public banks and governmental microfinancial organisations in several areas. A survey was conducted in 1999 by sending a questionnaire to the respective NGOs to collect their financial and programme information.

Credit is an important feature of the social structure of rural Bangladesh. The fact that a large number of people are affected by fluctuations in income and earning power induced by the seasonality of the agrarian economy implies that there is a persistent demand for credit, which can allow flexibility of consumption and investment over time. In the presence of poverty and uncertainty, the importance of credit is further enhanced when the difference between survival and uncertainty becomes visible during periods of generalised or specific disasters, whether those are floods, illness or disease or market failure. Such vulnerability makes the credit relationship a vital aspect of economic and social life in rural Bangladesh.

Control of credit is a source of economic and political power in Bangladesh. The wealthy have sufficient resources to meet requests for credit and the poor have chronic need for it. When disaster strikes, a poor household must be able to turn to someone known to him to ask for credit, with the expectation that their request will be met. This generates a patron-client relationship between the rich and poor in rural Bangladesh. As such, government programmes, which are

expected to intervene in rural areas to offer open access for the poor to credit at cheap rates, can be problematic.

The famous economic historian Joseph Schumpeter regarded the banking system and entrepreneurship as being two key agents in the whole process of development. The banking system is identified as the main mechanism through which scarce capital sources are gathered, multiplied through circulation, and channelled to their most productive and entrepreneurial uses in the economy. Therefore, banks facilitate the dynamics of the development process.

Microfinancial institutions (MFIs) successfully pioneered the microcredit delivery mechanism for lower income people in Bangladesh through small amounts of collateral-free affordable loans. One of the important characteristics of this type of loan is that it does not require any physical collateral to obtain loans from the MFIs. The guarantee by the group to repay individual loans became the hallmark of microlending, which integrates the rural community to the institutional credit market.

The development programmes of Bangladesh NGOs have evolved over the last two decades. Many NGOs starting as relief organisations have turned into development agencies. Gradually, many of them have become microfinance institutions (MFIs) by focusing on savings and microcredit programmes. Even for NGOs implementing other programmes like education, health services, skills training, agricultural development, microcredit has occupied the central place in their strategy. The range of financial services and sources of finance of some MFIs in Bangladesh may give the impression that they are behaving like (commercial) banks, except that they serve a different market (the poor) and do not have the legal backing to operate as banks. The programmes and methods of implementation are still evolving.

Over the last two decades the innovative microcredit programmes run by the famous Grameen Bank and hundreds of NGOs have contributed to improving the quality of life of millions of people,

mostly women, in Bangladesh. The success of Grameen Bank has encouraged hundreds of NGOs to start microcredit programmes. Presently, nearly 7.5 million men and women receive microcredit from the Grameen Bank and Grameen style MFIs and NGOs. Microcredit has proven to be an effective instrument for creating self-employment for millions of women and for increasing family income and consequently alleviating poverty [Hossain (1988), Alamgir (1998a)]. The mobilisation of resources by these NGOs/MFIs is critical for expansion of the outreach of such programmes, i.e. bringing more women and men under such programmes.

Although MFIs in Bangladesh basically follow the Grameen Bank model, all of them have introduced variations in their programmes, in the terms and conditions of their products and in the methods of implementation. They are different regarding their relationships with beneficiaries and in structuring their respective organisations. During the last two to three years, the trend has been to introduce new savings and loan products along with typical savings and microcredit services. There has been a conscious effort in mobilising local resources by introducing various savings and loan instruments.

The success of microcredit has attracted formal financial institutions, especially private commercial banks, into the microfinance sector. They have also introduced financial services of their own for the poor. This is a welcome initiative and has added a new dimension in microcredit. This has also opened up new sources of resources for the MFIs and ultimately for the poor. Similarly, MFIs are operating in urban areas to provide financial services to the poor, especially in slum areas. The special features of urban credit, if any, may be interesting for newcomers to urban credit. Some government agencies have also been implementing microcredit programmes.

This paper is divided into six sections. Following the Introduction (Section 1), Section 2 gives a comprehensive review of our methodology and findings of NGO activities in Bangladesh. Section 3 presents an overview of microcredit programmes for the poor in

Bangladesh. Section 4 provides a comparative analysis of six Islamic and secular NGOs. Section 5 examines the microcredit programme of Islamic Bank Bangladesh (IBBL), a private bank, and the Bank of Small Industries and Commerce Bangladesh Limited (BASIC), a semi-governmental bank. Section 6 examines the microcredit programmes of governmental banks and governmental organisations. Section 7 provides a summary, conclusion and policy suggestions.

2. REVIEW OF THE LITERATURE

The review in this Section has three objectives: (i) to sum up the types of research already performed; (ii) to evaluate the methodologies employed in each type of work, and (iii) to summarise major findings.

2.1 Classification of Studies

The studies on microcredit and on related issues are classified here into seven categories for clear understanding. Representative studies on each category along with their methodologies and findings are mentioned. However, these are not mutually exclusive groups. The categories of studies are: (i) Evaluation/impact studies; (ii) Comparative evaluations of more than one programme; (iii) Research on a particular issue; (iv) Sustainability analysis; (v) Short-term evaluation of performances of different organisations; (vi) Studies on management systems and the human resources of organisations, and (vii) Macro-policy studies.

2.2 Evaluation/Impact Studies

1. The pioneering impact study was performed on Grameen Bank by Mahbub Hossain [Hossain (1998)]. The study evaluated the credit programme by considering issues such as reaching target groups, the size of the loan disbursed, loan utilisation, the accumulation of capital,

the generation of employment and income, and poverty status. Along with the impact on the target groups, the study focused on the cost of operation and expansion of Grameen Bank. The data for this study were collected through field surveys in selected project and control villages in the area of operation of Grameen Bank. Fifteen branches of Grameen Bank were selected of which five were old branches. One village under each branch was randomly selected such that at least one male and one female centre were formed. For the survey on credit, all members belonging to the centres were interviewed through a structured questionnaire. The sample size consisted of 975 borrowers.

2. For assessing the impact of the credit programme, five villages belonging to the older branches were selected for the study. Two control villages were also selected. A census was first undertaken to collect information about land ownership and major sources of income for all households in the selected villages. The households were then randomly stratified into four land-ownership and two occupational (within each land ownership group) groups (farm and non-farm). A proportionate random sample was then drawn from each of the eight strata to get 40 sample households from each village. The total sample size of this survey was 320 households. These households were interviewed through structured questionnaires. The samples were classified into four groups: (i) Grameen Bank members in project villages; (ii) non-participants within the target group in project villages; (iii) the target group in the control villages, and (iv) the non-target group in both project and control villages. Groups (ii) and (iii) were used as alternative 'controls' to assess the impact of Grameen Bank by comparing their average characteristics with those for Group (i).

3. The findings of the study revealed that borrowers had increased their capital; loans had contributed to the increase in their employment; and there was a shift of employment from inferior

occupations, with respect to social status. Grameen loans increased the income and quality of life of the poor. The in-depth household survey showed that Grameen Bank members had about 50 percent higher income compared to the target group in control villages.

4. A follow-up study was done on Grameen Bank by Atiur Rahman [Rahman (1986)]. That study concentrated on the demand and marketing side of the product market of the borrowers of Grameen Bank in addition to the social and economic pattern of the borrowers. The study used a micro-level field investigation of Grameen borrowers, in a lower scale, one branch of the Bank, and the samples were not randomly selected. Similar to the findings of the first study, this study reported that borrowers selling marketable goods faced no demand constraint: "With the expansion of Grameen activities, the rural economy is getting commercialised and more people (especially the borrowers) are becoming job-specific." [Rahman (1986)].

5. A recent study [Mahmud and Mondal (1994)] suggested the methodology of using a 'with-without' approach for an impact study. The study design was comprised of a baseline survey. Target and control households were used for comparison. After completion of the project an in-depth detailed survey of the target group and a control group of non-members was conducted. A similar study with less coverage was done on the impact of the credit programme of the Association for Social Advancement (ASA) [Kayemuddin (1992)]. Of a total of 1500 borrowers in four branches who received loans three times, 200 borrowers were randomly selected for the study. In addition, secondary data were collected; interviews of ASA staff and other stakeholders were taken. The study reported improvement in income and in other social indicators of the beneficiaries due to the availability of loans.

6. One of the most recent studies was carried out on "Alternative Credit Delivery Systems" for the Thana Resource Development and Employment Project (TRDEP) [Department of Youth (1994)]. The

study looked into details of the working methods and practices of TRDEP, especially with regard to its membership selection, its field-level practices, its impact on the members and their families and its costs. In addition to a standard sample survey of beneficiaries of different phases of TRDEP, Rapid Rural Appraisal (RRA), social evaluation techniques and case studies were used to bring qualitative information not captured by survey methods. The study reported more or less similar results as those on Grameen Bank and recommended some changes in the operation of TRDEP. But the important difference was the use of other techniques in impact studies as complementary to the standard sample survey.

2.3 Comparative Studies of Programmes

1. The Bangladesh Institute of Development Studies (BIDS) carried out a major comparative study of poverty alleviation programmes in Bangladesh [BIDS (1990)]. It included ten programmes of eight organisations, both governmental and non-governmental. These programmes are BRDB-RPP, URDEP, SEDPW, Swanirvar, RESP, RDRS-CP, RDRS-RWP, BRAC-RDP SNSP and ASA. Investigations were carried out in 30 villages covering nearly 6000 households. Field investigations comprised household census and intensive sample surveys. Secondary data were collected from documents and interviews. The difference in this study was that it compared the same indicators for all programmes so as to compare relative success or failure.

2. As a part of the above study a comparative study [Bhattacharya (1990)] was done to compare the credit programme of BRDB-RPP, BRAC-RDP and TRDEP (formerly URDEP). The study made a comparative profile of participants (reaching the poor) in all three programmes, the delivery mechanism of their programmes and analysed the impact of the three programmes on income, employment and social indicators. Similar approaches as mentioned above, namely

structured questionnaires, were used for sample surveys. Financial data were used for cost comparisons. Similar approaches have been followed for evaluating the impact of poverty-alleviation programmes for individual organisations as well as for comparative studies.

2.4. Studies on Selected Issues

1. Many studies have been conducted on various issues relating to credit and poverty-alleviation programmes. One such study [Rahman (1989)] assessed the impact of the credit programme of Grameen Bank on the situation of rural women. A field survey to collect socio-economic data for the women involved was performed. The findings confirmed the improvement in life of rural women due to the availability of a loan. Research was conducted by BIDS to study the rural informal credit market. Three villages from three different areas of the country were selected. A census as well as sampling was used to obtain data for the study. It reports on various issues of the informal credit market, interest rates, loan sizes, sources and the uses of loan, etc. [Murshid and Rahman (1990)].

2. An interesting piece of research was conducted to examine the use of contraceptives by a savings group. Five villages in the programme and two control villages were selected randomly to conduct the study. A questionnaire based survey and in-depth discussion were used. The study reported a higher rate of contraceptive use in savings group members [Barkat-e-Khuda, et al. (1990)].

3. A team of BRDB conducted a comparative study on several governmental and non-governmental programmes. Informal interviews with key informants of these organisations, interviews with group members and analysis of documents were used to compare these programmes [Ahmed (1994)]. Similarly, to assess the activities undertaken by borrowers and the effectiveness of training behaviours

were investigated by BRDB for its programmes. A sample of 448 respondents was used [Mia (1994)]. The same BRDB Task Force made a comparative study on the interest rates of various credit programmes run by government departments and NGOs [Alam (1994)]. A similar study on ASA shows an improvement in borrowers' income and changes in their quality of life [ASA (1996)].

4. One critical area in a target-oriented poverty-alleviation programme is reaching the target group. For credit programmes, the target group is usually defined as the functionally landless (owning less than 0.5 acre of land) rural poor. There are 'hardcore' poor within the target group. But studies showed that credit programmes reach the better off sections of the poor, not the poorest of the poor. The programmes sometimes even included 20 to 30 percent non-target group members. A study on BRAC membership analysed the participation process and factors influencing participation in a credit programme [Zaman (1996)]. The study was based on a survey of 14 villages in Comilla district. Similarly, an analysis of the reasons for dropout from the ASA credit programme was done through discussion with members, field staff, and supervisors [Zaman (1996)]. It identified several reasons for dropout such as, the ceiling on the amount of the credit, the requirement of regular repayment, group discipline, preconditions for membership, the quality of field staff, etc.

5. Another area of research has sought to find ways to offer flexible financial services to the poor – be it in the area of savings or lending. Mandatory group savings are a precondition for receiving a loan. The rural poor need accelerated growth in savings for capital accumulation so as to come out of the poverty cycle. Organisations believing in the 'empowerment' and 'self-reliance' of groups emphasise that the groups should gradually act as independent 'institutions'. Researches on the possibility of becoming self-reliant are also being performed. One example is the study on Proshika [Wong, Kramsjo and Sabri (1996)].

2.5 Sustainability Analysis

1. The concept of sustainability includes four interrelated issues: financial viability, economic viability, institutional viability, and the borrower's viability [Khandker et al. (1995a)]. To assess the criteria for success one piece of research [Yaron (1992)] advocated two criteria: (i) self-sustainability and (ii) the level of outreach achieved with the targeted population. The financial self-sustainability of an organisation is achieved when the return on equity, net of subsidy received, equals or exceeds the opportunity cost of funds. The paper proposed a Subsidy Dependence Index (SDI) to measure explicit and implicit subsidies. Outreach then being measured by (i) the value and number of loans extended; (ii) the value and number of savings accounts; (iii) types of financial services offered; (iv) the number of branches and village post/units; (v) the percentage of total rural population served; (vi) the real annual growth of assets, and (vii) women's participation.

2. A study was done on the sustainability of Grameen Bank along the lines of the concept mentioned above [Khandker et al. (1995a)]. It assessed the financial and institutional viability of Grameen Bank. An estimation of subsidy and ways to eliminate subsidy were recommended. "Successful replications would depend not only on subsidized resources initially, but also on committed and dynamic leadership that is able to carve out market niches" [Khandker et al. (1995a)]. A similar study was undertaken on BRDB (RD-12) as well [Khandker et al. (1995b)]. It showed that the project carried a high economic subsidy. It had, however, the potential to reduce its subsidy dependence through the expansion of loans and membership.

2.6 Short Term Evaluation of Programmes

Researchers, consultants and donors' representatives sometimes conduct quick evaluations of programmes. In this type of research the principal methodology is the analysis of secondary data,

interviews with key personnel, evaluation of regular monitoring reports of the concerned organisation, visiting a few groups, discussions with field staff, etc. Two studies [Ghai (1984) and Siddique (1984)] on Grameen Bank were undertaken in 1984 to evaluate its operations. Important observations and lessons regarding the operation of rural credit were learnt. Similar studies on ASA [ASA (1994) and ASA (1996a)] have also been done to evaluate the financial and institutional performance of ASA.

2.7 Management Systems Studies

These studies emphasise the programme implementation process of a particular organisation. The assertion being that it is the implementation that really matters rather than a magic model. Two major studies on Grameen Bank that looked into the process have been done by Andreas Fuglesang (1988) and Susan Holcombe (1994). One looked into participation and the other into the management practices, human resources and culture of Grameen Bank. It is the culture within an organisation that really makes the difference. A similar study was done on ASA to trace the history of ASA and its evolution over time [Rutherfiord (1994)]. These studies contributed to an understanding of the process and the possibility of replication of a programme.

2.8 Macro Policy Studies

These are studies that have examined poverty-alleviation efforts on a national level. One such study is the country report on Bangladesh regarding strategies for enhancing the role of women in economic development [The World Bank (1990)]. A recent study reported the potential and constraints of development of the rural non-farm economy for alleviating rural poverty in Bangladesh [Khan (1994)].

3. MICROCREDIT PROGRAMMES FOR THE POOR IN BANGLADESH

3.1 Genesis of Microcredit and NGO Activities in Bangladesh

NGOs like BRAC, Proshika, RDRS, and many others, were founded on the wave of idealism and hope, which pervaded Bangladesh after Independence in 1971. They also drew upon the experiences of a young generation of Bangladeshis who had earlier been activists of some kind during the independence struggle or who had worked in relief programmes which were a necessary part of its aftermath. Each NGO evolved its own philosophy as to how it would work with the rural poor. Basically, one of the two approaches was taken by these NGOs. The 'conscientising' approach of NGOs development argues that the roots of poverty in Bangladesh lie in the fact that the poor are systematically disorganised by economic, social and political relationships within which they are caught. Therefore, the only long-term solution to the problems of poverty in Bangladesh lies in assisting the poor to challenge the relationships that impoverished them and this can only be done by increasing the awareness of the poor so that they can collectively demand escape from exploitation. The 'materialist intervention' approach argues that the rural poor need more than consciousness; they need material assistance to help them generate the incomes to escape from the grip of poverty. Credit is considered a key element in this approach, and this credit would allow the poor to break away from their dependence on moneylenders and to invest in their own employment generating income [McGregor (1994)].

The Grameen Bank Project started in 1976 as an action research project in the neighbourhood of Chittagong University. Much of its approach was reminiscent of lessons, which were being learnt in the FAO's (Food and Agricultural Organisation) ASARRD Project (Asian Survey of Agrarian Reform and Rural Development), which was being operated in three areas of Bangladesh. The Grameen Bank focused specifically on the delivery of credit to the rural poor, with the

underlying belief that while conscientisation was important, poor people first needed tangible assistance to work their way out of poverty. From its beginning in Chittagong, the Grameen Bank became a Bangladesh Bank-sponsored experimental project and expanded, using existing nationalised commercial banks (NCBs) and Bangladesh Krishi Bank (BKB) branches, to operate in Tangail and Rangpur Districts. After encountering difficulties in their working relationships, it disassociated itself from the banking system and set up as an independent organisation with its own branches. As its profile grew and its coverage expanded in the early 1980s, it became a scheduled bank with government representation on its board. In line with its original philosophy, however, its borrowing and saving members continued to hold the majority stake in the organisation.

3.2 Overview of Microcredit Programmes in Bangladesh

The poor and the landless in Bangladesh, as elsewhere, do not have access to a formal financial system for credit. However, recently some commercial banks have introduced microcredit for the poor following the path of the Grameen Bank and NGOs. Although these initiatives are admirable they are limited in coverage. The human resources, structures, and products of commercial banks are not geared to serving the poor. Their targets are very different sectors of the economy. The formal financial system is based on collateral, which the poor do not have and it requires huge volumes of paper work to process a loan. Eventually, the poor resort for credit to the informal sector, for example, moneylenders, to meet their consumption and investment needs and end up paying usurious rates of interest. But there exists huge demand for small amounts of credit by the poor for investment. To circumvent the situation, Professor M. Yunus of the now famous Grameen Bank, has innovated a system of credit delivery to the poor without collateral, popularly known as microcredit. Presently, microcredit has reached an unprecedented scale and is expanding fast in Bangladesh. All major NGOs are

expanding their outreach by including new members as well as raising the average credit per member. The poor men and women are mobilised into groups to receive credit so that they take the responsibility of repayment of each other's loans.

Yaron (1992) has observed that one key to the success of NGOs and other MFIs appears to be the introduction of a social mechanism that lowers transaction costs, while supplying effective peer pressure for screening loan applicants and collecting loans and, thus, lowering delinquency rate and leading to a viable operation. The absence of the above-mentioned features in the formal segment thus calls for the adoption of those features in their lending strategy, instead of being intervened by government in the form of providing cheap and politicised credit to rural customers.

Generally, MFIs serve the lower income groups who often have very limited assets. Traditional collaterals for obtaining bank loans like property, land and machinery are mostly not available to them. So, usually, the mechanism of MFIs does not require collateral security for providing loans. Rather they have introduced some innovative methods to minimise the risks of their operations. They use some collateral substitutes and a number of alternative forms of collateral for reducing the risk of loan loss. One of the most commonly used collateral substitutes is peer pressure, either on its own or jointly with group guarantees. The group guarantee is a very popular form of collateral on the part of many MFIs. MFIs facilitate the formation of group and group members provide guarantees for each other's loans. The guarantees may be of two kinds. In one case, no member is able to have access to a loan if all members are not current in their loan payments and in case of the other, all members are equally liable if other group members default on their loans. Some MFIs even require group members to contribute to a group guarantee fund, which is used if one or more borrowers fail to repay. Some MFIs lend to people of a particular community based on their good reputation. Before disbursement of the credit, the employees of the MFIs usually

collect information regarding their activities, to know about the potential client's character and capacity. In some cases when a new borrower is unable to provide security, credit officers rely heavily on information as a collateral substitute. Maintaining close contact is the most effective collateral substitute for small credit to the poor. For example, frequent visits of the credit officers ensure that the client is maintaining the business. This allows the institution to understand the appropriateness of the loans in terms of amount, frequency of payments, etc. This is also a very important instrument that contributes to developing mutual respect between borrowers and the institution in regard to the commitment to their work. Moreover, the risk of public embarrassment and the risk of legal action may also work as a very good collateral substitute. In such cases, the institution makes the clients feel that they will be embarrassed in front of a number of neighbours or there are risks of legal action against them [Ledgerwood (1999)].

There are some popular alternative forms of collateral used by microfinancial institutions. One of the most widely used is the provision of compulsory savings. It implies that the clients must save a certain percentage of their income to obtain credit from the institutions. This is usually kept in the form of a percentage of the loan and is sometimes known as contributions to group funds. This cannot be withdrawn when the loan amount is outstanding. This is a form of saving which is made compulsory for most MFIs' clients and is different from voluntary savings that generally permits withdrawal of funds. Most compulsory savings are available for withdrawal only at the end of the loan term. This also works as the contributory factor for the development of saving habits in the poor. Sometimes assets are pledged (such as furniture, appliances, etc.) as security to realise the loan amount. This sends the message to the borrowers that the MFI is serious about loan repayment. Personal guarantees from friends, relatives or any respected person of the area are also accepted as security by some MFIs.

The typical microcredit programme has the following key features: (i) it is collateral-free so that the poor and the landless may easily avail themselves of it; (ii) to get a loan, the poor members are mobilised into groups, ranging from 5 to 30 members by a particular MFI; (iii) the members meet once every week and make a small savings deposit with the concerned MFI. After another waiting period, which varies from two weeks to six months, members receive a loan and take collective responsibility for repaying the same; (iv) loans are usually given for one year and recovered in weekly instalments. A few MFIs recover loans in monthly instalments; (v) the field staff of MFIs supervise utilisation of the loan; (vi) the loans are usually provided for common, petty trades, and other activities in rural areas, so that the members can pay weekly instalments. Some organisations give more than one loan to their members, like a house loan, a seasonal agricultural loan, etc.; (vii) the majority of borrowers (as high as 90 percent) are women; and (viii) MFIs usually establish branches in remote areas that help poor members in receiving loans. The field staff collect loan instalments at the meeting held at the members' premises. The procedure for receiving a loan has been greatly simplified, making the programme very attractive to poor and illiterate villagers. The MFIs have simple but detailed accounting and management information systems to handle large numbers of borrowers. The MFIs start with a small loan (Taka 1-3 thousand, or US$ 25 to 75) and provide repeater loans of increasing amounts as long as repayment of any earlier loan is satisfactory. This system allows for the continued flow of credit funds since the poor need regular access to credit to maintain and expand their economic activities. This also ensures good repayment [Alamgir (1999)].

Microcredit creates a virtuous cycle to break the vicious cycle of poverty. The infusion of credit creates self-employment for the borrower, increases income leading to increased consumption/ savings, additional (and continued) credit increases further income and so on, and thus a borrower is expected to come out of poverty.

The poor, especially women, have benefited from such microcredit programmes, demonstrated by their increased income and assets (net of credit). Many impact studies [Alamgir (1998a), Hassan and Renteria (1997), Hossain (1988), BIDS (1990)] show that microcredit recipient households have a better standard of living, improved housing, higher human development status and greater assets and have shifted away from moneylenders. In most cases, there is significant improvement in social indicators, such as children's school enrolment, fertility rates, and the use of clean drinking water.

3.3 The Microcredit Sector in Bangladesh

Microcredit has become the core programme for nearly all NGOs working with the rural and urban poor in Bangladesh. Other programmes are now playing supportive roles. The demand for microcredit from the poor and the opportunity of achieving financial viability have encouraged NGOs to introduce microcredit in a big way. Although there are several hundred NGOs registered in Bangladesh, approximately 200 NGOs have reasonably large microcredit programmes. Four large MFIs dominate the sector, the Grameen Bank, a formal specialised bank for the poor, the Bangladesh Rural Advancement Committee (BRAC), Proshika and the Association for Social Advancement (ASA). At the end of December 1998, there were nearly 7.5 million borrowers of which the Grameen Bank had 2.36 million.[1] BRAC, Proshika, and ASA served 2.02 million,[2] 0.74 million[3] and 0.714 million[4] borrowers respectively. The 148 small and medium MFIs (SM-MFIs) financed by the Palli Karma-

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[1] Source: The Grameen Bank, "Consolidated cumulative statement as of December, 1998".

[2] Source: BRAC, Dhaka

[3] Source: Proshika, Dhaka

[4] Source: ASA, "ASA at a glance (Up to December 1998)". Monthly monitoring report of ASA.

Sahayak Foundation (PKSF) reached 0.61 million[5] borrowers. Other NGOs and government programmes serve the remaining borrowers.[6] A total amount of Taka 37,083.74 million (US$ 772 million) was disbursed by Grameen Bank (Taka 19,119.4 million), BRAC (Taka 8,340.15 million), Proshika (Taka 2,774 million), ASA (Taka 4,862.8 million) and 148 small and medium MFIs financed by PKSF (Taka 1,987.31 million) during 1998.[7] The outstanding loans of these organisations at the end of December 1998 were Taka 36,654.69 million (US$ 733 million).

The microfinance institutions (MFIs) and NGOs in Bangladesh have been following basically two strategies – the microcredit programme as the only programme (Grameen Bank, ASA) or microcredit plus other non-lending services such as skills training, social awareness, education, health, agricultural development, etc. (BRAC, Proshika, RDRS). However, in the case of NGOs microcredit has gradually taken over the central role because of members' demand for financial services and also because it offers the opportunity for financial viability to NGOs. Although the basic savings product, the mandatory weekly/monthly savings, and the basic loan product, the one-year loan, are similar, MFIs have started experimenting with new and varied savings and loan products. A number of variations have been introduced both in savings and credit programmes. Both strategies, 'credit only' and 'credit plus', have experienced tremendous success in terms of outreach and repayment performance (more than 95 percent). But as the terminology suggests, NGOs are increasingly becoming financial institutions. The interest rates vary between 18-30 percent and most NGOs charge nearly 30 percent, more than double the formal financial sector. Medium and large MFIs

[5] PKSF, "Summary of PKSF's Loan Programme, December 1998".

[6] There may be a difference between the actual number of borrowers and the sum of the borrowers of each of the organisations mentioned here, because in some instances the same person might have borrowed from more than one source.

[7] Compiled by the author based on the data from various MFIs.

have already demonstrated their ability to become operationally and financially viable. One critical aspect of the microcredit sector is the dependence of MFIs on grants for expanding their outreach. Gradually, the sector has been shifting towards a loan-based capital structure due to the intervention of PKSF as well as due to the greater thrust on mobilisation of savings. But the limiting factor for further expansion of outreach – both horizontally and vertically – is still mainly the inadequacy of MFI resources.

3.4 Microcredit Information of Banks, MFIs and NGOs

The mobilisation of weekly savings is an important part of the microcredit programme. The net savings mobilised by 369 NGOs including BRAC, ASA, and Proshika at the end of June 1998 was Taka 4,288 million. An analysis of areas of disbursement by these 369 NGOs shows that the loans are given mainly for common traditional activities in the rural economy. The major sectors are small businesses (42.13 percent), livestock (17.44 percent) and agriculture (12.19 percent). (See Table 4.1.)

Banks take part in the poverty-alleviation programmes through a direct approach and through linkage with MFIs. During 1991-92 and 1997-98 the collective cumulative disbursement of five banks (Sonali, Janata, Agrani, BKB, RAKUB) in the poverty-alleviation programmes amounted to Taka 4421.46 crore (see Table 4.2). It is encouraging that the recovery rates of some microcredit programmes (especially the programmes that were initiated during the last few years) are far better compared to the overall repayment situation of commercial banks. Most of these credit programmes share common features such as loans without collateral, disbursement through homogeneous groups, some mandatory savings, close supervision, etc. Some other banks like BASIC Bangladesh Limited, Employment Bank, Ansar VDP Bank, Cooperative Bank, etc. have some collateral-free credit programmes for the poor. In September 1998, the Employment Bank started its operation in Bangladesh with the objective of providing

credit supports to the educated unemployed youth for income generating activities. For loans of up to Taka 50,000, the Bank does not ask for any collateral. The Bank distributed Taka 6.4 million to 315 clients up to February 28, 1999 [Ministry of Finance (1999)].

The clientele of collateral-free credit of MFIs comprises basically a large number of rural poor, the landless, unemployed youth, women and small entrepreneurs. Mostly, MFIs provide funds for non-farm activities and to some extent to agricultural activities also. Grameen Bank is the first leading institution in Bangladesh to substitute material collateral with social collateral for its lending among the rural poor people. Their coverage in terms of number of members and areas is increasing day by day. The overall loan disbursement, outstanding loans and savings[8] of the MFIs increased by a substantial amount during the last few years. Some NGOs are also extending microcredit in urban areas. Until August 1999, Grameen Bank, the largest microcredit institution,[9] had an outreach of 2.36 million members of which more than 2 million were women [Grameen Bank (1999)]. Out of the 495 reported NGOs, 130 NGOs have credit programmes for urban people. However, 94.52 percent of their disbursements are concentrated in rural areas [CDF (1998)]. Among the notable MFIs, other than Grameen Bank, some of the largest NGOs in Bangladesh such as BRAC,[10] ASA, Proshika, etc. are involved in the collateral-free credit activities in Bangladesh (see Table 4.3).

[8] Up to August 1999, Grameen Bank members have mobilised savings amounting to Taka 9114.2 million and the Bank has disbursed a loan amount of Taka 111239.1 million. Up to December 1998, the NGOs (of 495 major institutions) have disbursed Taka 66565.50 million. Total active members were 7,864,004 of which outstanding borrowers were 5,415,490. Net savings of the members were Taka 5216.26 million of which about 70 percent is being used in revolving the loan fund.

[9] Until August 1999, Grameen Bank hnd expanded its operation to 39,501 villages through its 1142 branches.

[10] BRAC has 2,252,000 active members who saved a total of Taka 1996 million. Up to December 1998, it disbursed a cumulative loan amount of 25601 million to its members. All the figures are the maximum among the NGOs (CDF, 1998).

Among the microcredit institutions the performances of formal sector banks and governmental organisations are not that extensive and praiseworthy. Though the outreach, repayment performance, savings mobilisation of all the existing collateral-free credit programmes of NCBs, BKB and RAKUB are showing remarkable improvement, the overall performances of the banks and Government Organisations (GOs) in terms of outreach, involvement of funds, etc. are not yet comparable with those of Grameen Bank and other successful NGOs like BRAC, ASA, and others (see Table 4.4).

Formal credit plays an even smaller role in crop production than in non-crop and rural non-farm production. Between 1983-84 and 1993-94 crop GDP accounted for more than 72 percent of agricultural GDP, while crop credit accounted for only about 51 percent of total formal credit. But crop credit declined by 1.8 percent over this period and non-crop credit grew by 2.2 percent. Thus, rural production is still largely self-financed. Non-crop financing seems to be preferred over crop financing by formal sector banks because it is less risky [Khandker (1998)]. On the other side, MFIs' credit seems to have a larger role than that of formal sector banks in agriculture in Bangladesh, and its role is growing. As of December 1998, out of the cumulative total disbursement of major NGOs of Taka 50858.86 million, Taka 6336.05 million were disbursed as agricultural loans. This represents 12.46 percent of the total cumulative disbursement of loans of these institutions as compared to 12.19 percent in June 1998 (CDF, 1998). Moreover, the important point is that all these loans are collateral-free and are maintaining good repayment rates.

Following the success of the MFIs in the field of microcredit, banks have introduced a number of collateral-free programmes replicating the models of microfinance in their poverty-alleviation programmes. In some programmes they are directly lending by forming groups and in some other cases banks are providing funds to the NGOs for efficient disbursement. Though their overall performance is not as good as the MFIs, (see Table 4.5), still it has

been observed that the microcredit programmes of the banking sector that are based on the 'group lending' approach have been showing comparatively better results. The outreach and repayment performances of these programmes are also noteworthy.

Most of the microcredit programmes of MFIs are maintaining very good repayment performances (see Table 4.6). Microcredits are mostly generating income, which is the basis for the good repayment performance from the borrowers' side. From the point of view of the institutions, the main reasons are better loan sanctioning and strict supervision both by employees and at the group level. Moreover, the MFIs provide a number of support services like training, technical supports, etc., to their clients. Due to close supervision and monitoring the extent of credit diversion is very little.

4. COMPARATIVE ANALYSIS OF SECULAR AND ISLAMIC NGOs

4.1 Sample NGOs

Islamic NGOs: there are only a few NGOs currently operating in Bangladesh that provide microfinancial services based on Islamic principles. This is a very recent phenomenon. Consequently, these NGOs are very small in terms of their membership. The Rural Development Scheme of Islami Bank Bangladesh Ltd. is the largest in this sector. We have selected five NGOs and RDS to make the comparison. Tables 4.7 and 4.8 provide basic information on membership, borrowers, savings, disbursement and the rate of recovery of these NGOs.

Secular NGOs: for the sake of comparison, NGOs of similar size have been selected. However, these NGOs are relatively more experienced and have been operating in this sector for several years. For comparison of these two groups of NGOs the emphasis has been on the system and mode of operation of microfinance programmes.

Table 4.9 provides a comparative analysis of the microfinancial services of the two groups of NGOs.

4.2 General Findings

Islamic NGOs are late in coming to the field of rural development in general and microcredit/micro-investment in particular. On the other hand several hundred secular NGOs have been implementing microcredit programmes since the 1980s. Discussions with leaders of Islamic NGOs reveal that they were late to appreciate the role of NGOs and, in fact, had hostile opinions about the activities of secular NGOs. Gradually, some of them appreciated that credit programmes can be implemented by blending Islamic principles of investment and mechanisms for mobilising the poor, that is, the management practice of implementing microcredit programmes.

Islamic NGOs have been managing mainly micro-investment/ microcredit programmes while secular NGOs are implementing other programmes like non-formal education, health and sanitation, etc., mainly with the financial assistance of external donors.

In their microcredit programmes both groups of NGOs follow the same selection criteria for their beneficiaries. In fact, Islamic NGOs follow the existing norms of selecting the poor in rural areas. Normally, families having a maximum of 0.5 acres of land are included in the programmes.

Gender issues: the existing bias among NGOs is to include mostly women in their programmes. Islamic NGOs include both men and women. However, one Islamic NGO (Islamic Cultural Society) accepts men as members, and the Islami Bank accepts mainly women like secular NGOs.

Microcredit mechanism: Islamic NGOs have basically copied the microcredit mechanism developed by the Grameen Bank followed by all NGOs in Bangladesh. However, there might be small variations introduced by each NGO to suit its own situation. The basic

mechanism is as follows: poor women and men are organised in groups who take responsibility for the repayment of each other's loans in the event of default. Groups meet once a week to make the transactions, deposit savings and loan instalments.

One basic requirement for receiving a loan is to deposit a small amount of money as 'compulsory savings'. Islamic NGOs also follow the same procedure because it gives poor members an opportunity to mobilise their own capital. It is a kind of cash collateral for the NGO and a part of the loan/investment operation may be financed by this fund. However, one important distinction may be noted here regarding payment of interest on members' deposit. Secular NGOs pay a fixed rate of interest, 5-6 percent per annum, on the deposit. On the other hand, Islamic NGOs provide a variable rate similar to Islamic Banks. The rate is computed at the end of the year considering total income and expenses.

Normally NGOs do not allow members to withdraw their savings deposits. Muslim Aid, however, does allow its members to withdraw their savings.

The most significant difference between the Islamic NGOs and other NGOs centres on the issue of interest. Secular NGOs charge at the rate of 20-30 percent per annum on the cash credit provided to members. However, Islamic NGOs do not provide any cash by way of loan. They apply the concept of '*bay' mu'ajjal*' (sale on credit) and provide the commodity adding a certain percent of mark-up on the cost of the commodity. The rates vary among various organisations. For example, Islami Bank adds 12 percent and Muslim Aid Bangladesh adds 12.5 percent on the cost over a period of one year. Since the payments by the members are made every week, when computed according to the method of finance the corresponding rate of interest would be approximately 24 percent and 25 percent respectively.

The other terms and conditions of credit of these two groups of NGOs are similar. The loans are given for a period of one year and recovered in weekly instalments. The amount of loan for both groups of NGOs varies between Taka 3000 to Taka 10,000.

The activities financed by both groups of NGOs are the same, commonly available petty activities in rural areas. Examples are poultry and livestock rearing, petty trade, financing agricultural inputs, rural vehicles, housing materials, handlooms, etc.

Sources of funds: common sources of funds for microcredit programmes are members' savings, grants from external (Western) donors and currently from the Palli Karma-Sahayak Foundation (PKSF), an organisation established by the Government of Bangladesh to provide loans to successful NGOs. Islamic NGOs are fund starved although they have ample opportunity to expand and there is strong demand in rural areas for Islamic microfinancial services. Only Islami Bank has adequate resources to expand its microfinancial services. Four Islamic NGOs in the sample received some funds from PKSF. International Islamic donor agencies normally do not provide funds for microcredit. They are more interested in relief and rehabilitation programmes. Islamic NGOs also lack guidance for improving their management and professional skills. This makes Islamic NGOs followers rather than leaders in the sector.

Future trends: both groups of NGOs will be focusing on two issues: expansion of programmes by accepting more and more members and achieving the financial viability of their programmes.

5. COMPARATIVE ANALYSIS OF ISLAMI BANK BANGLADESH LIMITED AND BANK OF SMALL INDUSTRIES AND COMMERCE BANGLADESH LIMITED

The microfinance programmes have so far been operated by the Grameen Bank, NGOs and some nationalised commercial banks. Private commercial banks have shied away from microfinance programmes, especially from directly organising the poor in rural areas. The main reasons are as follows: (i) this is not their mandate;

(ii) financial return in microcredit is pretty low; (iii) the banks do not have the outreach in rural areas to mobilise the poor, and (iv) the private banks do not have the right kind of human resources to manage microcredit programmes.

The Islami Bank Bangladesh Limited (IBBL) is an exception in this respect. It has appreciated the benefit of microcredit programmes for poverty alleviation. At the same time it has recognised the need for the right kind of human resources for managing microcredit programmes. IBBL has a microcredit wing, separate from normal commercial banking with staff trained in the management of microcredit. It initiated its Rural Development Scheme (RDS), the formal name of its programme, in 1996.

The major objectives of RDS are (i) to alleviate poverty; (ii) to expand the investment programme of the bank in rural farm and non-farm activities; (iii) to reduce and gradually eliminate usurious money lending, and (iv) to provide investment in housing in rural areas. The institutional mechanism of RDS is similar to the common microcredit programme. The poor beneficiaries (persons having less than 0.5 acre of land) are mobilised into groups, they meet once a week, repay the loan in weekly instalments, loans are free from collateral, and women outnumber men in receiving loans. But the striking difference is the mode of investment. RDS does not give credit in cash; it follows the Islamic mode of investment in implementing RDS. The main mechanisms are leasing (*ijārah*), *bayʿ mu'ajjal*, hire-purchase, etc. Unlike many MFIs, RDS-IBBL provides credit for both farm and non-farm activities, for the purchase of tubewells and for building houses. Table 4.10 summarises the areas of investment, the maximum amount of loan, and the duration of the loan, etc.

As outlined above, the duration of RDS credit varies between one to three years depending on the type of activity. Since loans under RDS-IBBL are in kind, it uses a mark-up on the cost of the product (cost plus mark-up). The mark-up is 12 percent. IBBL divides the income from RDS as follows: profit to the bank is 6 percent, the

supervision fund is 4 percent, and the risk fund is 2 percent. The equivalent rate of interest via the conventional method of interest computation is 24 percent. However, one significant difference of RDS-IBBL is that it rebates one fourth of mark-up income, i.e. 6 percent to the borrower if his/her repayment is regular. That makes the rate of return of RDS-IBBL 18 percent, one of the lowest in the microcredit sector. Similar to other MFIs, RDS-IBBL prefers women as the main beneficiary of the programme. The minimum amount of savings in RDS is Taka 5, and members are free to save any amount since every member has to open a savings account in the Bank. There is no legal restriction for RDS regarding the mobilisation of savings since it is a bank programme.

IBBL has more than 100 branches of which 45 have introduced RDS for poverty alleviation. Within two years of its operation RDS-IBBL had mobilised 12,115 members (80 percent are women) in 148 villages. Until September 1998, it had disbursed Taka 105.3 million and outstanding loans amounted to Taka 36.5 million. The number of borrowers was 7,980. The rate of recovery was more than 96 percent. The key indicators of the programme are summarised in Table 4.11.

The areas of investment of RDS are given in Table 4.12. It appears that RDS is also investing in activities commonly financed by other MFIs. However, RDS is new and small compared to the whole operation of the Bank. IBBL has a portfolio of Taka 15,000 million, but the outstanding loans under RDS amount to only Taka 36.5 million. But it plans to reach 2000 villages by the year 2001 with an outstanding loan of Taka 2000 million, an average of Taka 1 million in each village. This would represent a substantial investment and commitment on the part of a private commercial bank. The institutional mechanism of credit delivery is similar to that of Grameen Bank and other MFIs. The important difference is that the Islamic modes of investment have been proven to be equally applicable in reaching the poor. The duration and ceiling of loans are

slightly different than typical microcredit and sometimes overlap the microenterprise programme of some MFIs.

The Bank of Small Industries and Commerce Bangladesh Limited (BASIC), a private bank, offers microcredit to the urban poor through linkage with non-governmental organisations (NGOs) with a view to facilitating their access to the formal financial market for the mobilisation of resources. BASIC's microcredit programme is targeted at borrowers of urban and suburban areas. This is probably because it has 21 branches (as at the end of 1997) in urban centres. BASIC offers three types of financial services: (i) lending to the NGOs (wholesale lending); (ii) lending to the poor by bank management, and (iii) lending directly to the poor with NGOs providing non-financial services like group formation, monitoring and supervision in exchange for a supervision fee. The third approach is discussed here. This method of financial service by BASIC is a perfect match for both parties – BASIC not having its own microcredit outreach to mobilise the poor by its own staff and a particular NGO not having financial resources to provide microcredit to its members.

In the case of BASIC, it provides microcredit to borrowers at the rate of 16 percent. BASIC receives 10.5 percent and the concerned NGO receives 5.5 percent as a supervision fee. The members repay in weekly instalments and the NGO repays the loan to BASIC in monthly instalments. Loans are disbursed by BASIC personnel and collected weekly by the NGO officials.

BASIC Bangladesh has some credit programmes for small and cottage industries and for weaker sections of the urban areas (see Table 4.15). BASIC does not seek collateral up to Taka 50,000. BASIC is also serving a collateral-free programme under the Credit Guarantee scheme of Bangladesh Bank. Since inception, the Bank has disbursed Taka 694 million (up to March, 1999) of which 74 percent is distributed in the cottage and small industry sector. Up to December 1998, the Bank's loan for poverty-alleviation programmes amounted

to Taka 122.42 million to the urban poor through direct approach and linkage with the NGOs.

The two private banks are following two approaches: (i) mobilising and lending by its own staff, and (ii) lending to the members of NGOs. Both approaches seem to be working but the total commitment of funds will always be small compared to the total portfolio of the banks. It will require more time to make an informed judgement on the viability of private banks, microcredits given the relatively low rate of return of the microcredit programme. Besides, the management issue may become serious because two completely different types of activities are being conducted under the same roof.

6. COMPARATIVE ANALYSIS OF MICROCREDIT SERVICES OF GOVERNMENT BANKS AND GOVERNMENTAL ORGANISATIONS (GOs)

The collateral-free rural credit programmes under the banking sector got a big push in 1977 when the Special Agricultural Credit Programme or SACP (widely known as Taka 100 crore SACP) was launched throughout the country. All four nationalised commercial banks (NCBs) have been implementing the special credit programme without seeking collateral under this programme. Then, during the 1990s, a number of collateral-free credit programmes for rural agricultural and off-farm activities with simplified procedures were initiated by the nationalised commercial banks and the agricultural development bank (BKB, RAKUB) of Bangladesh. It is noteworthy that most of their credit programmes are designed for comparatively higher income groups that seek collateral security. This small portion of bank collateral-free credit is mainly concentrated in the rural sector that consists of some project ioans (mainly channelled through government, donor agencies, etc.) and a portion of the agricultural credit of banks. At present, banks' microcredit programmes and most of their agricultural crop loans are collateral free.

Sonali Bank, the largest public sector bank, has raised its agricultural loan disbursement[11] by a considerable amount during the last few years and has undertaken some special programmes for the lower income groups of rural areas (see Table 4.16). In February 1993, Sonali Bank initiated a special agricultural investment programme to support small investors in the agricultural sub-sectors like pond fishery, commercial poultry, cattle rearing, etc., with a close monitoring system. The programme seeks no collateral for the loan amount up to Taka 50,000 from their 230 selected branches. Up to December 1998, the recovery rate was 66 percent, and about 80 percent of the total disbursements under this programme were collateral free. Other NCBs, Agrani Bank (see Table 4.17), and Janata Bank (see Table 4.18) also have a good number of collateral-free credit programmes for crop and non-crop activities. Of all the banks, BKB[12] is the prime source of agricultural credit. All of the crop loans and maximum portions of the rural credit of BKB are collateral free (see Table 4.19). The Bank targeted a distribution of total Taka 12500 million as credit in the year 1998-99. RAKUB has a number of agricultural programmes for the rural areas of the Rajshahi division.

Beside these institutions, the Palli Karma-Sahayak Foundation (PKSF) and Bangladesh Rural Development Board (BRDB) are also playing an important role. PKSF is widely treated as a 'second tier' microfinance organisation primarily lending to the MFIs for on-lending to final borrowers. It is mainly a government-initiated organisation supported both by the government and donor agencies for its operation. Until December 1998, PKSF disbursed loans of Taka 4682.835 million to 178 MFIs. Another source of collateral-

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[11] According to the Ministry of Finance source, in 1998, Sonali Bank distributed a total amount of Taka 3935 million in the agricultural sector, which represented Taka, 2868 million in the year 1997.

[12] BKB is the biggest supplier of agricultural credit with its share during 1986-91 averaging about 60 percent of the total agricultural disbursement. The NCBs of Bangladesh supplied 25 percent during the period (ADB, 1993).

free microcredit is the ministries and directorates through which government channelled a considerable amount to the lower income groups. Among the government organisations, BRDB is playing a good role as a collateral-free credit delivery organisation. The main projects of BDRB have focused on poverty alleviation. BRDB distributed Taka 10303.7 million in 440 *thanas*[13] from 1990-91 to 1997-98 [Ministry of Finance (1999)].

Many studies have shown that the formal sector has little success in reaching the rural poor mainly because of high transaction costs both from their own as well as the borrowers' point of view. Moreover, their interest rates are set between 10 to 14 percent, which is much lower than the 20 percent charged by Grameen Bank, and BRAC [Khandker (1998)]. These have been discouraging the formal financial institutions from providing large-scale agricultural and micro-financial services, and it is reflected in the insignificant percentage of investible funds of the formal institutions in their microcredit programmes. It is also observed that whatever amount has been involved or whatever microfinancial projects have been undertaken by the formal institutions, they are mostly donor-driven.

In fact, after various financial sector reform measures, the share of NCBs and specialised banks (BKB and RAKUB) in rural as well as the microcredit market has been reduced. Because of high transaction costs and low repayment rates, these banks are not interested in undertaking such financing activities. In order to induct the banks in microcredit programmes through overcoming the above-mentioned problems, Bangladesh Bank has undertaken the initiative of encouraging the banks to establish linkage schemes (with the NGOs). Now, not only the NCBs and specialised banks, but also some of the PSBs[14] have started linkage programmes with NGOs and all the programmes are running very well. In some cases, banks are found

[13] *Thana* is a small administrative unit within a municipality.

[14] Private sector banks.

to create an impediment to expansion of linkage programmes by asking collateral for providing funds to NGOs.

Government owned specialised banks that mainly deal in project loans and crop loans in rural areas are facing a very difficult situation in regard to the repayment position. Their sources of funds are not their deposits, rather they depend heavily upon foreign aid and government allocation as well as borrowing from Bangladesh Bank. There have been frequent cases of rescheduling, waivers of interest, loan forgiveness, etc., and the default position of these banks is worse than the commercial banks in the areas of loan classification and provisioning. It is interesting that though NCBs had to extend a portion of loans for social considerations, PSBs' loan default position is not much different from that of NCBs. This implies that it has not been proved that privatisation can solve this problem in the banking sector.

7. CONCLUSIONS AND POLICY IMPLICATIONS

Bangladesh is a Muslim country with 130 million people who are suffering from high poverty and a low growth syndrome. A number of NGOs and governmental organisations (GOs) have been working diligently for the last 25 years to eliminate poverty in Bangladesh. Yet, there has been a very marginal gain in the poverty-alleviation exercise in Bangladesh. Islam looks upon poverty as a religious and social problem, which pushes a person to lowliness, sin and crime. Hence, why the Prophet (peace be upon him) sought Allah's refuge from it: "O Allah, I seek Your refuge from poverty, insufficiency and lowliness" (Abū Dāwūd). It may even lead to killing an innocent soul. The Qur'ān teaches us: "*Kill not your children for fear of want, We shall provide sustenance for them as well as for you. Verily, the killing of them is a great sin*" (17:31). The Prophet (peace be upon him) linked poverty to disbelief: "Poverty is almost like disbelief in God". (al-Bayhaqī). So, poverty is a threat to man's beliefs and

character and to the security and stability of society. This is why Islam focuses on poverty alleviation as priority number one. It is incumbent on society to confront poverty as a social threat by all possible means in order to establish a healthy community.

Islam has enjoined upon the state as well as community to share the responsibility of eliminating poverty from society. The economic philosophy of Islam aims, at first, to eliminate poverty by providing basic human needs, narrowing the gap between the rich and the poor, and developing the resources of the earth for the welfare of human beings for whom everything in heaven and earth is made subservient. Within the boundaries of its economic philosophy, Islam has provided many ways to cure the problem of poverty. Some of these are the responsibility of the state, others are to be fulfilled by society and some are a shared obligation of both the state and society.

Islam prescribes tackling the issue of poverty head on. It provides laws and the legal-institutional framework for the resolution of poverty. It suggests policies and various operational mechanisms to meet the basic needs of the affected groups. It simultaneously proposes short-run and long-run solutions. A comprehensive approach to the problem of poverty, on the one hand, suggests having a programme of well-targeted transfers and safety nets for those poor who are unable to work or suffer deprivation due to some reason. On the other hand, it suggests a strategy, which promotes the productive use of the poor's most abundant asset, labour. This requires economic policies, market incentives, socio-political structure, and technology that are geared toward those ends. Simultaneously, the provision of social services like basic education, primary health care, and food and nutrition are critical in meeting the basic needs of the poor as well as ensuring their continued social health and productivity. Islam views poverty as denigrating human dignity and preventing a human from fulfilling his duties in this world.

Islamic NGOs should take a comprehensive approach, including creating the awareness of people about social problems and their

role in solving them. This is not a gender-based approach, especially focused on men or women. The focus of Islamic NGOs will be family, even when a recipient of the project turns out to be a woman. Such NGOs should have a proportionate balance between men and women beneficiaries. Islamic NGOs should try to reach the hard-core, which secular NGOs have failed to reach. Christian missionaries have targeted these hard-core poor by providing them with food, shelter and education. Islamic NGOs should evolve into a social movement by bringing welfare to the grass-roots.

Islamic NGOs should make a genuine effort to utilise mosques and involve the *'ulamā'* and those who are committed to Islam. The *'ulamā'* need a new orientation that brings them face-to-face with the realities of the modern-day world. Their religious identity, with a practical social orientation, will help to restore the confidence in Islam in general and in those who are supposed to be at the vanguard of Islam in particular. Islamic NGOs should try to be self-financed by developing a savings habit among its beneficiaries. They should emphasise rural savings as part of their long-term programme of poverty alleviation. Loan disbursement and savings mobilisation should not be the only objectives; they should also provide meaningful basic Islamic education to their beneficiaries.

Ribā, a major sin in Islam, has penetrated the whole fabric of Bangladeshi society through the microfinance activities of secular NGOs. Islamic NGOs should, as a long-term mission, replace interest-based microfinance activities by Sharī'ah-approved lending mechanisms. By mobilising *zakāh* funds and fund-raising, Islamic NGOs should be able to make a significant dent in the longer-term goal of eradicating poverty and usury and interest in Bangladesh. The NGOs should gradually incorporate *muḍārabah* and *mushārakah* mechanisms to attract investments from well-to-do Muslims, and integrate them in the whole process of poverty alleviation.

The government should help Islamic NGOs by giving them interest-free loans, which they can invest in various activities designed

to benefit the poor. The government of Bangladesh should as a policy promote means to eradicate *ribā* from society to save it from the long-term negative impact of *ribā* on economic growth and development. The government can at least provide finances from its *zakāh* funds to Islamic NGOs so that they can provide microfinancial services in Sharī'ah-approved ways to the needy and poor. A study by Hassan and Ahmed (1998) has shown that in Bangladesh *zakāh* funds can replace the government budgetary expenditures in an amount anywhere from 21 percent of annual development funds (ADP) in 1983/84 to 35 percent of ADP in 1994/95. This amounts to 649 crore Taka in 1983/84 to 3,479 crore in 1994/95. The government can use this amount of money in other developmental or social expenditures either by itself or giving them to Islamic NGOs. Because of its fixed and recurrent nature, *zakāh* allows the government to make a long-term strategy in combating poverty. In spending *zakāh* funds, priority should be given to the poor in the same region from which it has been collected. This creates a healthy feeling of solidarity between the rich and the poor of that region.

We should also remember that Islam puts more emphasis on the role of society in easing poverty than on the role of the state, because it desires it to be a form of voluntary worship that cements brotherly relations between believers and because society is closer to the needy than the government. Islam instructs Muslims to take care of their close relatives. The Prophet (peace be upon him) says: "The hand of the giver is the upper one, and start with your dependents: your mother, father, sisters and brothers, then the nearest of kin." [*Sunan al-Nasā'ī*, Vol. 5, Beirut, Dār al-Fikr, p. 61]. Imām Abū Ḥanīfah made it obligatory on a Muslim to support the needy among his close relatives even if they were nonbelievers. It is allowed for the ruler to fix a certain amount of money on a man who refuses to support his needy relatives, especially his parents and minor sisters and brothers.

A regulatory body is essential to monitor the activities of MFIs in Bangladesh. A mechanism could also be introduced to assess the performance of MFIs. A microcredit rating committee or organisation

could be helpful in this regard. But an independent and professional team of assessors must do the credit rating and risk assessment. The rating would help the best performers to obtain access to the resources of the formal financial institutions, government and donor community. Moreover, an intermediary guarantee issued for a loan or line of credit to MFIs for on-lending can help greatly to raise a higher proportion of funds by MFIs from the banking sector. A guarantee service in the form of insurance could also be an essential element to protect the assets of MFIs. Compulsory deposit insurance for MFIs might also be helpful in taking care of the interests of small savers.

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Table 4.1: Sector-wise Distribution of Loans of 369 NGOs including ASA, BRAC and PROSHIKA

Sector	% of Disbursement (Until June 1998)
Agriculture	12.19
Fisheries	4.33
Food processing	10.17
Small business	42.13
Cottage industries	2.83
Transport	3.39
Housing	1.49
Health	0.51
Education	0.04
Livestock	17.94
Others	4.81
Total	100.00

Source: Credit and Development Forum (CDF), 1998.

Table 4.2: Cumulative Disbursement of Banks, Microcredit (Taka in Million)

Bank	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98
Sonali Bank	490	514	491	959	1159	1105	3108.85
Janata Bank	98	111	154	361	483	818	738.16
Agrani Bank	56	73	191	229	316	354	205.14
BKB	132	170	356	651	993	1128	340.36
RAKUB	38	56	78	87	83	86	28.96
Total	814	924	1270	2287	3034	3491	4421.47

Source: CDF Statistics, Volume 7, December 1998 and Ministry of Finance, 1999.

Table 4.3: Growth of the Collateral-free Microcredit Programme of BRAC, ASA and PROSHIKA (December 1997 and December 1998)

	BRAC		ASA		PROSHIKA	
	Dec.97	**Dec.98**	**Dec.97**	**Dec.98**	**Dec.97**	**Dec.98**
Loan Disbursement (Taka in Million)	21607	29955	7263.4	13559.1	5406.1	8185.2
Total Members	2011417	2484045	805631	894119	1231883	1242867
Net Savings (Taka in Million)	1750	2237	721.0	1081.1	10.5	471
Total Outstanding (Taka in Million)	3686	4921.1	1566.9	2218.5	2090	2678.9

Source: CDF Statistics, 1997-98

Table 4.4: Disbursement of Credit for Poverty Alleviation by MFIs, Banks and GOs (Taka in Million)

	June 1998 (Cumulative)	**% of Total**
GOs	16063.40	7.75
NGOs	53644.0	25.89
Banks	39289.80	18.97
Grameen Bank	98171.1	47.39
Total	207168.3	100.00

Source: Ministry of Finance, 1999 and CDF Statistics, 1998.

Table 4.5: Recovery Performance of the Microcredit Programmes of NCBs and GOs

Name of Bank/Organisation	Recovery Rate as % (up to June, 1998)
Sonali	88.94
Agrani	99.21
Janata	80.15
BKB	71.58
RAKUB	81.99
BRDB	87.81
Ministry of Youth & Sports	68.53

Source: Ministry of Finance, 1999.

Table 4.6: Recovery Performance of Some NGOs and Grameen Bank

NGO/GB	Recovery Rate as % (up to Dec. 1998)
BRAC	98.20
ASA	99.96
PROSHIKA	95.47
Total of all NGOs	93.18
Grameen Bank	92.10[15]

Source: CDF Statistics, 1998 and Grameen Bank (1999).

[15] Recovery rate up to August 1999.

Table 4.7: Membership and Savings Information of NGOs Under the Study (end of June 1999)

Name of the NGO	Membership			Savings	Beginning year of microcredit
A. Islamic NGO	Men	Women	Total		
1. Al-falah A'am Unnayan Sangstha, Dinajpur	60	4031	4091	5,435,000	1994
2. Islamic Cultural Society, Jhalakati	2083	0	2083	1,266,00	1997
3. Noble Foundation and Literary Society, Bogra	15	900	915	760,000	1997
4. Rural Economic Support and Care for the Underprivileged, Rangpur	57	2354	2411	1,610,000	1992
5. Rural Development Scheme of Islami Bank Bangladesh Ltd.	5067	20268	25335	12,077,000	1996
6. Muslim Aid Bangladesh	1055	55	1110	1,136,558	1993
B. Secular NGO					
1. Sagarika Samaj Unnayan Sangstha, Noakhali	2125	3484	5609	3,827,000	1993
2. Shaplaful, Bagerhat	0	1466	1466	416,000	1994
3. Programmes for People's Development, Sirajganj	27	2697	2724	3,188,000	1994
4. Palli Mangal Karmasuchi, Dhaka	0	5984	5984	7,846,000	1995
5. Society for Social Services, Tangail	523	27010	27533	40,000,000	1991
6. Noabeki Bazaar Cooperative Society, Sathkhira	835	8115	8950	8,447,000	1992

Source: Annual Reports of Respective NGOs

Table 4.8: Disbursement, Borrowers, Recovery of Microcredit (end of June 1999)

Name of the NGO	Cumulative Disbursement (Taka)	Outstanding (Taka)	Borrowers (#)	Rate of recovery (%)
Islamic NGO				
1. Al-falah A'am Unnayan Sangstha, Dinajpur	44,611,000	8,104,000	2956	99.67
2. Islamic Cultural Society, Jhalakati	17,494,000	5,273,000	1858	95.16
3. Noble Foundation and Literary Society, Bogra	9,051,000	1,582,000	781	99.89
4. Rural Economic Support and Care for the Underprivileged, Rangpur	25,412,000	3,127,000	1804	99.00
5. Rural Development Scheme of Islami Bank Bangladesh Ltd.	190,027,700	70,098,600	16,494	99.00
6. Muslim Aid Bangladesh	25,449,500	4,310,872	1110	80.00
Secular NGO				
1. Sagarika Samaj Unnayan Sangstha, Noakhali	42,675,000	5,679,000	2274	98.42
2. Shaplaful, Bagerhat	11,511,000	1,843,000	785	99.24
3. Programmes for People's Development, Sirajganj	26,377,000	5,165,000	2093	99.05
4. Palli Mangal Karmasuchi, Dhaka	72,617,000	19,132,000	4857	99.99
5. Society for Social Services, Tangail	565,681,000	81,867,000	24149	98.32
6. Noabeki Bazaar Cooperative Society, Sathkhira	70,823,000	15,398,000	4971	99.94

Source: Annual Reports of Respective NGOs

Table 4.9: Comparative Analysis of the Two Groups of NGOs

Issues	Islamic NGOs	Secular NGOs
Target group of NGOs	Generally, rural poor are the target population. Members can own a maximum of 0.5 acres of land. Islami Bank also includes marginal farmers having a maximum of 1.5 acres of land.	Generally, rural poor are the target population. Members can own a maximum of 0.5 acres of land.
Criteria applied for selection of members	Land ownership criteria	Land ownership criteria
Area of Operation	Rural area	Rural area
Gender	Both men and women are included in the groups. One NGO within the sample works only with men. The clear bias is to accept men but Islami Bank prefers women.	Normally, women are preferred by NGOs to form groups, although a small percentage (5-10 percent) of members are men. One NGO within the present sample of NGOs works only with women.
Programmes	Mainly micro-investment	• Mainly microcredit • Non-formal Education • Water and sanitation
Group size	5 to 30 members per group/society	5 to 30 members per group/society
Frequency of meeting	weekly/monthly	weekly/monthly
Terms and conditions of savings		
Savings of members	Taka 5-10 per week	Taka 5-10 per week
Interest/profit paid on savings	Variable: 5-6 percent per annum	5-6 percent per annum
Other savings instruments	None	None
Withdrawal of savings by members	Members are allowed to withdraw a certain percentage of savings.	Members are allowed to withdraw a certain percentage of savings.

(Continued on p. 159)

Table 4.9: Continued

Issues	Islamic NGOs	Secular NGOs
Terms and conditions for loan		
Amount of loan Maximum Minimum Duration of loan.	Taka 3,000. Taka 15,000 (Islami Bank). One year.	Taka 3,000. Taka 10,000. One year.
Rate of interest/mark-up.	12-15.5% mark-up (24-25%) rate of interest	30% per annum.
Mode of repayment.	Weekly instalments	Weekly instalments.
Type of loan.	Islamic mode of investment is used – mainly *bay' mu'ajjal* (sale on credit.)	Loan is provided in cash.
Activities financed.	Common activities available in rural areas especially petty trading, rearing poultry and livestock, agricultural input, shopkeeping, rural vehicles.	Common activities available in rural areas especially petty trading, rearing poultry and livestock, agricultural input, shop-keeping, rural vehicles.
Multiple loans.	Only one loan at a time.	Only one loan at a time.
Sources of Fund.	• Members Savings (in case of Islami Bank – depositors' savings). • PKSF.	• Members' savings. • PKSF. • International donors.
Future Trends.	Expansion. Financial viability. Institutional strengthening.	Expansion. Financial viability. Institutional strengthening.

Source: Survey of 12 Secular and Islamic NGOs.

Table 4.10: Area of Investment, Loan Ceiling and Duration of Loan from Rural Development Scheme of Islamic Bank Bangladesh Limited (RDS-IBBL)

Area	Upper Ceiling (Taka)	Duration	Other Conditions
Crop production	10,000	One year	21 selected crops
Fisheries	25,000	Max. 3 years	—
Irrigation	5,000	Max. 1 year	—
Agricultural Equipment	25,000	Max. 3 years	Equity 10%
Non-farm activities	10,000	Max. 1 year	343 items; weekly repayment
Rural Transport	5,000	Max. 2 years	Weekly repayment
Tubewell	3,000	Max. 3 years	At least 2nd time borrower
Housing Materials	15,000	Max. 3 Years	At least 3rd time borrower

Source: RDS, IBBL, October 1998

Table 4.11: Key Indicators of RDS of IBBL (September 1998)

Indicators	Achievement
Number of Branches (#)	45
Villages covered (#)	148
Number of centres (#)	597
Groups (#)	2423
Members (#)	12115
Borrowers (#)	7980
Cumulative disbursement (Taka million) since 1996	105.3
Loan outstanding (Taka million)	36.5
Rate of recovery	96%

Source: RDS-IBBL, 1998

Table 4.12: Area of Investment of RDS (until November 1998)

Number	Areas of Investment	Cumulative Number of clients	Cumulative Disbursement (Taka in million)
1	Agriculture	2,385	15.09
2	Manufacturing	551	3.95
3	Services	1,572	9.69
4	Trade	6,674	42.40
5	Shops	2,012	13.75
6	Small Vendors	191	1.26
7	Nursery	75	0.51
8	Livestock	5,413	35.98
	Total	18,879	122.63

Source: RDS, IBBL, November 1998

Table 4.13: A Comparison of SIBL and Non-Banking FIs and NGOs

SIBL Approach	Non-Banking Financial Institutions and NGO Approach
1. Microcredit for empowering family: ensuring joint liability of wife and husband in case of lending to family, or groups of families without collateral.	1. Microcredit for decomposing and eventual disintegration of the family. For example: Grameen Bank's credit empowers women as opposed to man (i.e. over 95% of its clients are women).
2. No ceiling and floor: microcredit covers hard-core poor also (i.e. street children in the urban slum and is tailor-made)	2. Main criterion for membership in many NGO's disbursing loans is a ceiling on a land holding of no more than half an acre and no less real in practice and a floor on the level of income.
3. Credit linked to culture as rooted in Islamic values provisioning for perpetual social capital accumulation.	3. Credit is interest based, not in conformity with the Sharī'ah.
4. Credit provisioning on a nominal profit or non-profit basis (i.e. flat rate 9% and public health credit @ 6% per annum. At present Formal Banking expected profit/return rate varies from 16% to18%.	4. Interest rate 25% to 35% for the poor. In many cases defaulters are forced to sell their meagre assets or to go to local moneylenders who could charge up to 120% interest.
5. In the event of loss (due to factors beyond control) there is a provision for sharing the loss and Social subsidy out of "social fund".	5. There is no such provision of sharing for losses, rather there are reports of ruthless force used towards defaulters.
6. Providing Deposit Savings and Investment services and schemes to up-scale their operations.	6. This facility is limited in scope and coverage.
7. Assisting microcredit/enterprises with provision for credit access to the formal Banking of SIBL, thereby, allowing the poor to cross the frontiers of non-formal Banking.	7. Working on the threshold and does not provide credit access to formal Banking.
8. Credit based on depositors funds, and no external grant/loan.	8. 75-100% based on external grant.
9. Recovery of loan about 97% (confirmed by External Auditor).	9. Recovery reported to be 95-97%.
10. Financial Accountability subject to scrutiny by Statutory External Auditors and Central Bank.	10. They are not subject to such control.

Table 4.14: Microfinance and Developmental Activities of SIBL

a. Family Cluster-wise Savings and Investment Projects for Microcredit Programme Under Family Empowerment Social Financing Schemes:				
				Figure in Taka
			2000	**Growth Rate**
	1998	**1999**	**31st May**	**1998/May 00**
a) Amount of Savings	4,426,408	7,259,946	8,291,853	87%
b) Amount of Investment	27,994,834	47,502,370	53,332,410	91%
c) Amount Due	15,181,245	31,872,059	38,681,261	—
d) Amount Recovered	14,610,770	30123897	35,681,874	144%
e) Rate of Recovery (%)	96.24%	95%	92%	—
f) Amount of Total Outstanding	13,153,609	17,378,473	17,650,536	—
b. Family Empowerment Micro Enterprise Programme				
a) Amount of Savings	5,57,718	16,369,636	24,566,202	4304%
b) Amount of Investment	5,57,718	2,430,489	5,438,951	—
c) Amount Due	5,01,200	2,061,655	6,924,364	1282%
d) Amount Recovered	90%	85%	100%	—
e) Rate of Recovery (%)	56,518	14,307,981	17,641,838	—
f) Amount of Total Outstanding	13,210,127	31,686,454	35,292,374	—

Fig. in Thousand

	1998	**1999**	**31st May, 00**
c. Cash *Waqf* Account (Opened)	215	457	591
Amounts (Taka)	1249	3881	4324

Table 4.15: Collateral-free Credit of BASIC Bank as at 30th September, 1999

(Amount in Lac Taka)

Sl. No.	Programme/ Project	Disbursement		Recovery	Outstanding	Overdue	% of Recovery
		No.	Amount				
1	Microcredit	—	1226.80	—	687.00	—	98
Credit Guarantee Scheme of Bangladesh Bank							
1	M. Rahman & Company		1.60	0.08	2.14	—	100
2	Capital Board Mills		4.00	1.63	2.41	1.43	53
3	Shikha Chemicals Complex		8.00	6.51	3.74	0.54	92

Source: BASIC Bank, 1999

Table 4.16: Collateral-free Credit of Sonali Bank (as at 30.06.99)

No	Project's Name	Disburs-ement	Recovery	Outstan-ding	Arrears/ Overdue	No. of Benefi-ciaries	Reco-very (%)	Average Loan Size Thou-sand
1	Rural Poor Cooperative (ADB-supported)	2665.7	2205.6	611.1	26.6	533140	99	5
2	RDP-9 (EEC-supported)	441.3	384.1	113.7	28.9	88260	93	5
3	RD-2 RPP (CIDA-supported)	198.4	188.4	128.6	128.6	66133	60	3
4	SWRDP (IFAD-supported)	22.3	21.1	22.7	22.7	7433	50	3
5	NWRDP (ADB-supported)	167.1	148.8	55.8	55.8	55700	75	3
6	SIRDP (ADB-supported)	54.4	69.0	38.0	38.0	18133	64	3
7	IRWDP (100% SB finance)	1023.4	845.0	260.8	52.2	204680	94	5
8	Crop lending (100% SB supported)	6892.6	6340.2	4104.1	2878.8	1378520	69	5
9	TCCA Shrimp (100% SB supported)	107.1	83.6	31.9	4.2	21420	94	5
	Sub Total	11572.3	10285.8	5366.7	3235.8	2373419		
10	Agro-based micro enterprises	587.8	370.5	366.8	158.5	23512	70	25
11	Swanirvar credit (with Swanirvar Bangladesh)	407.4	311.1	399.3	342.5	81480	48	5
12	Assetless (With BMET)	174.8	118.6	138.3	93.3	58266	56	3
13	MSFSCIP (IFAD/ GTZ supported)	35.9	27.7	12.7	3.9	7180	88	5

(Continued on p. 165)

Table 4.16: Continued

No	Project's Name	Disbursement	Recovery	Outstanding	Arrears/ Overdue	No. of Beneficiaries	Recovery (%)	Average Loan Size Thousand
14	RDA-SB microcredit	9.0	4.8	4.7	–	3000	100	3
15	BARD -SB microcredit	5.7	5.0	1.4	3	1900	97	3
16	Micro Branches	245.2	309.4	112.0	82.0	49040	79	5
17	Special Agricultural Credit	16301.0	15502.2	11896.6	9037.9	2874740	58	5
18	CUMED (Credit for Urban Women M. Entrep. Devp)	1.8	0.2	1.7	–	12	100	
19	NGO Linkage	11.9	0.1	12.0	–	–	100	
20	Others	20.1	18.0	5.1	5.1	6700	77	3
	Sub Total	17800.6	16667.6	12950.6	9726.2	3105830	63	
	TOTAL	29372.9	26953.4	18317.3	12962.0	5479249	67	

Source: Sonali Bank, 1999

Table 4.17: Collateral-free Credit of Agrani Bank (01.01.98 to 31.12.98)

No	Programme/ Project	Disbursement		Reco-very	Outstan-ding	Over-due	% of Recovery
		No	Amount				
1	Productive Employment Project	65958	3387.54	3073.52	2139.27	85.09	97
2	Daridra Bimochon Karmasuchi	4042	284.55	161.06	376.62	103.79	61
3	Marginal and Small Farm System Crop Intensi. Project	196	96.18	77.67	155.03	32.32	71
4	Small Enterprises Development Project (SEDP)	3855	1173.51	784.92	749.57	41.04	95
5	Khudra Uddyog Prokalpa	170	24.51	7.27	24.33	0.10	99
6	Financing in small-scale cottage industries	83	6.91	2.53	8.14	0.29	90
7	Kurigram Poverty-Alleviation Project (KPAP)	7990	370.60	422.82	502.00	173.12	71
8	Swanirvar Credit Programme	4560	174.10	126.29	1754.84	1546.41	8
9	Rural Finance Project	2130	136.39	109.71	656.40	475.92	19
10	Shoshya Gudam Rin Prokalpa	700	18.22	13.98	11.97	0.63	96
11	Small-scale Poultry Farms	36	5.25	4.80	10.55	5.22	48
12	Self Employment	164	11.23	6.19	95.93	84.23	7
13	Rural Transport	133	5.30	3.45	25.78	10.28	25
14	Rural Electri-fication	0	0	0.28	3.97	2.35	11
15	Normal credit	574	52.39	40.74	154.70	100.26	29
16	Crop Loan	157091	8452.32	3390.44	26067.51	16321.93	17

(Continued on p. 167)

Table 4.17 continued

No	Programme/ Project	Disbursement		Recovery	Outstanding	Overdue	% of Recovery
		No	Amount				
17	Crop Diversification	520	31.77	49.73	197.06	154.31	24
18	DANIDA	0	0	1.75	45.77	45.77	4
19	RPP	0	0	1.96	1162.44	1162.44	0
20	Credit Scheme for Salt Growers	131	14.00	8.38	40.72	21.72	28
	Total	**248333**	**14244.77**	**8287.49**	**34182.60**	**20367.22**	**29**

Source: Agrani Bank, 1999

Table 4.18: Collateral-free Credit of Janata Bank (1998–1999)

(Figure in 100,000 Taka)

Programme/ Project	Disbursement		Recovery	Outstanding	Overdue	Recovery During the Year (%)
	No.	Amount				
A. Poverty Alleviation						
SFDP	9645	552.98	555.35	1175.40	566.21	49
MSFSCIP	75	15.05	13.68	68.02	27.54	33
Swanirvar	4000	131.12	88.12	1187.22	1034.36	7
Cooperative Credit Prog.	480	332.45	293.40	1181.08	772.49	27
Acqua Culture Extn. Projects	–	–	–	0.06	0.03	–
North West Fisheries Extn. Projects	78	1.71	1.02	1.33	0.04	96
Storage Cum Credit Programme	150	11.67	7.45	9.89	0.63	93
Diversified Credit Programme	6106	2341.22	2261.05	4730.08	1257.03	64
Family Based Microcredit	558	62.03	32.11	84.00	16.98	65
IFAD (Cox's Bazar)	–	–	2.11	26.95	26.95	7
NGO	1	75.00	–	75.00	–	–
B. Crop.		**87738.00**	**76512.80**	**31077.03**	**17064.76**	**81**

Source: Janata Bank, 1999.

Table 4.19: Collateral-free Credit of Bangladesh Krishi Bank (1998–1999)

(Figures in Thousands of Taka)

No.	Programme/Project	Disbursement	No.	Recovery	Overdue	Outstanding
1	Rural Credit (Asstt. Prog)	2300	3	5129	–	2352
	Tea Leaf Producer	1836477	74	1679937	56243	1225436
2	Shrimp Culture	84054	1107	52462	90048	210070
3	Fish Loan (Jall Mahal)	296	5	368	20421	24866
4	Salt Grower	1219	157	625	79847	81246
5	Nursery	–	–	17	–	137
6	R.F.P (Recycling)	–	–	248	21592	23165
7	Swanirvar	71359	13054	38547	268336	364925
8	BISIC (Joint Programme)	–	–	–	–	–
9	WEDP	10664	1689	11237	48562	71312
10	UNCDF	4403	506	2960	31574	43182
11	VWSEPT	8570	1137	7166	6981	37188
	CROP					
1	Aus & Aman	1178603	162762	651950	748348	2001152
2	Boro	2973758	426286	1392903	2207779	6425532
3	Wheat	25354	4428	11218	75507	119469
4	Potato	1672065	156651	714155	733218	2636601
5	Sugarcane	841205	71239	333454	332697	1442681
6	Mustard	17973	4093	7129	10257	36878
7	Peanut	10689	1352	8222	10801	25613
8	Tobacco	2895	407	3525	1992	5714
9	Banana	146521	7148	37747	30821	203160
10	Vegetable	69499	7891	26220	12063	91438
11	Irrigation Equipment	–	–	51	2373	2373
12	CROP under CDP	40808	2309	6404	9921	50376
13	LLP	–	–	5	–	771

Source: Bangladesh Krishi Bank, 1999

COMMENTS

*Abulhasan M. Sadeq**

1. INTRODUCTION

The authors deserve credit for an interesting and informative paper, which examines the microfinancial services of secular and Islamic NGOs and some other organisations that deal with microcredit, and also compares their performances. In doing this, the paper discusses the role of microcredit in Bangladesh, reviews the studies and literature on NGO activities with special reference to their methodologies, highlights the microcredit programmes for the poor in Bangladesh, and then provides a comparative analysis of secular and Islamic NGOs, and of some private and public sector banks and organisations. We shall make an attempt not only to make some comments on the paper but also to contribute by adding some important aspects of microcredit in the Bangladesh scenario, which have not been covered in the paper under discussion.

There have been three different approaches to the critical evaluation of microcredit in the context of Bangladesh: the

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mainstream approach, the left-oriented approach, and the socio-cultural approach. The paper under discussion deals mainly with the positive aspect of the mainstream approach, both in its literature review and its own analysis, while the negative side has been marginalised. About one-third of the paper has been allocated to the literature review, mostly to report the methods taken in these studies and their findings. What is missing in most of the cases is a critical evaluation of the studies. In some cases, only their methods of analysis have been reported, without reporting their findings. Furthermore, the other two approaches, namely, the left-oriented approach and the socio-cultural approach, have not been reviewed,[16] although the socio-cultural approach is very much relevant in our context. It would be useful to take care of this gap in the paper.

1.1 Microcredit, Poverty Alleviation and the Quality of Life

According to the authors, "the innovative microcredit programmes run by the famous Grameen Bank and hundreds of NGOs have contributed to improving the quality of life of millions of people". In the valuation of microcredit, it is probably the most important point to make and to examine whether it has really been able to contribute to poverty alleviation and the improvement of human life. The space allocated to this aspect seems to be less than what is needed and the point not really substantiated. This aspect could be usefully developed by some supporting data. Therefore, we provide in Table 4.20 some data from a performance study of an NGO, namely, BRAC.[17]

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[16] The issue of women empowerment has, however, been covered, which has both an economic as well as socio-cultural dimension.

[17] See David Hulme and Paul Mosley, *Finance Against Poverty*. London: Routledge, 1966, p. 134.

Table 4.20: Monthly Income Changes 'before and after the Last Loan' and at the time of Interview

Borrower Group	Average monthly income 'before' (Taka)	Average monthly income 'now' (Taka)	% increase (nominal)	% increase adjusted by rural consumer price index	% increase adjusted by retail price index
First-time borrowers	1,575	1,792	13.8	6.6	1.1
Third-time borrowers	1,401	1,679	19.8	12.3	6.4
All borrowers	1,513	1,752	15.8	8.6	2.8

Source: Prepared from Tables 12.16 and 12.17 from David Hulme and Paul Mosley, *Finance Against Poverty*, London: Routledge, 1966, p. 134.

As one can see from Table 4.20, the income of borrowers has increased, but quite marginally, which cannot possibly make any significant contribution in poverty alleviation and in improving quality of life. Many studies highlight such positive effects of microcredit on income, although the effects are not substantial.

However, such claims of the positive income effects of microcredit have also been disputed by many others. For example, a reputed economist of Bangladesh, Dr. Khaliquzzaman, has been reported to have said, "these fashionably named projects – poverty elimination project and the project to augment the production ability of the poor etc. – have not brought about any change in the economic structure" in Bangladesh.[18] According to Adity Chowdhury, nowhere has BRAC (a large microcredit provider) been successful in changing the socio-economic conditions of the poor, rather "with its superior resources, BRAC has become a new elite in the village, taking the place of political parties without a strong programme to defend its activities."[19]

[18] See Syed Serajul Islam, "Impact of Technology and NGOs on Social Development: The Case of Bangladesh", *Journal of South Asian and Middle Eastern Studies*, Vol. XXI, No. 2, 1998, p. 64.

[19] Adity Chowdhury, *Let Grassroots Speak: People's Participation, Self Help Groups and NGOs in Bangladesh*, Dhaka: University Press Ltd., p. 109.

Another point deserves attention in this area. Although poverty alleviation is a declared agenda of microcredit, it rarely reaches the poorest of the poor in the country. Ironically, microcredit reaches the better-off section of the poor, and not the poorest of the poor. Sometimes the programmes include as high as 20 percent - 30 percent non-target group members. It is difficult to understand why the poorest of the poor are excluded from microfinance. The reason is not expected to be non-availability of collateral, since microcredit is provided mostly with non-material collateral, which is even stronger than material collateral and is equally accessible to the poorest of the poor.

Thus, the point made in the paper under discussion about the positive effect of microcredit on the quality of life of millions of people probably cannot be taken without reservation and qualification.

1.2 Self-employment, Self-sufficiency, or Perpetual Dependence on Credit?

According to the paper, microcredit is an effective instrument for creating self-employment. It is a conscious effort to mobilise local resources by mandatory group savings, which should save the poor from the burden of indebtedness. However, some people may question this and the long-term implications of microcredit. Microcredit does not make the borrowers self-sufficient, but rather it seems to have trapped the borrowers into the vicious circle of loan and indebtedness. The loan given to the poor is rarely sufficient to finance an economic activity properly so that the borrowers can stand on their own feet. They are in need of credit continuously, without which they cannot survive. The credit trap makes the borrowers so dependent on credit that they will be even more vulnerable without it. One may probably also question the sincerity of NGOs in making the borrowers self-sufficient and in their poverty-alleviation agenda when they charge 30 percent interest on their loans, while they pay only 5-6 percent interest on the forced savings of the microcredit borrowers. What is

the rationale or justification for this practice? It amounts to receiving from others in full measure, while paying less to them, which is condemned in Islam[20] and probably so in any rational mind.

1.3 Microcredit Without Collateral?

It is a general notion, as mentioned in the paper under discussion that microcredit is advanced without charging collateral security for loans. The issue is not as simple as it appears. We need to differentiate between material collateral and non-material collateral and examine the phenomenon.

Material Collateral: the general belief is that microcredit is free of material collateral. This is not necessarily true and one must qualify this view. This is for two reasons. First, each and every member (receiver of microcredit) must save a certain amount and must deposit it with the respective MFI, which cannot be withdrawn. Obviously the mandatory savings work as a collateral. Second, sometimes assets, for example, furniture, appliances, etc., are pledged as collateral. Third, some MFIs require formal collateral to provide credit. For example, Grameen Bank, the inventor of microcredit, requires material collateral for advancing credit amounting to a certain magnitude, which is termed as the Grameen Fund.

Non-material Collateral: some collateral is non-material in nature. First, group pressure or peer pressure works as a strong non-material collateral in microcredit. A member can get credit only and only when all members are up-to-date in loan payment and all members are liable if any member becomes a defaulter. Thus, the group liability and group pressure constitutes a non-material collateral. Second, personal guarantees from friends, relatives or other respected persons of the locality are also accepted as a sort of collateral by MFIs. Therefore, microcredit is not really collateral

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[20] Al-Qur'ān (83:1-3).

free. It requires collateral, whatever its form might be. However, we must acknowledge that most of these collateral are accessible to the target group of population to obtain loans from MFIs, which may not be available for loans from the formal sector.

1.4 High Recovery Performance?

A general understanding about microcredit is that its recovery and repayment rate is very high (90–95 percent), which is very encouraging. This is seen as an element of success of microcredit. However, on deeper scrutiny, the picture does not seem to be so impressive. Some informal interviews by us with a cross-section of people dealing in some way or other with microcredit, reveal some interesting facts.

First, microcredit is taken from multiple agencies. When a recipient of microcredit is unable to pay back the loan, he/she takes a loan from another MFI and pays back the earlier loan. In this case, the recovery is zero in the true sense of the term, since the credit has merely been transferred from one MFI to another. Second, often loans are repaid by taking loans from rural moneylenders, who charge exorbitant rates of interest. This loan is then used to repay the microcredit of the respective MFI, and then credit is taken once again from the same MFI, which is paid back to the moneylenders. In the record of the MFI, there is a full recovery which is not so in reality. Third, in some cases, MFIs renew credit to the defaulters. It is considered that the loan has been repaid and then a new credit has been extended. The book of accounts shows a full recovery of credit, which is not really so in reality. Fourth, in some cases, the debtors sell their scarce properties to repay the loans due to group pressure and to avoid public embarrassment. In such cases, the repayment is obviously not a proof of performing microcredit.

Besides, it is a fact that the recovery rate of rural credit is better even for other commercial banks and, thus, the good performance in

rural recovery is not specific to MFIs. Thus, the reported high recovery rate of loans is questionable, although one must acknowledge the fact that group pressure and close supervision may contribute positively to loan recovery, which is specific to supervisory MFIs.

1.5 Dependence on External Donations and Extremely High Administrative Costs

As mentioned in the paper under discussion, secular NGOs depend heavily on external donations. Although the authors have not provided any supporting data for this, we can substantiate this by evidence, which is alarming. A World Bank report states: "A micro-sample survey of budgets of ten leading local and international development NGOs in Bangladesh indicates that, in 1990-91, foreign sources accounted for 94 per cent of the total budget amount of US$5.3m (Tk. 189.4m)."[21] Accordingly, NGOs are considered as competitors of the government for scarce foreign assistance.[22] During 1992 to 1994, the disbursement of official aid to NGOs as a percentage of total Official Development Aid (ODA) was about 11 percent, which obviously presents NGOs as competitors of the Bangladesh Government in availing themselves of scarce external resources.[23]

This phenomenon raises a question, which is as follows. The secular NGOs advance a huge amount of credit, charge a very high rate of interest (30 percent), and the recovery rate is extremely high (95 percent). Thus, the NGOs should earn a very large amount of income from its own sources (along with foreign assistance received in the first few years). Then, why are the NGOs so dependent continuously on external donations? The paper under discussion seems to have overlooked such questions. The answer may possibly

[21] World Bank. *Bangladesh: Pursuing Common Goals*, Dhaka: University Press Ltd., 1996, p. 43.
[22] Ibid., p. 46.
[23] Ibid., p. 45.

be found in another fact, which too has not been covered in the paper, and that is the unusually high administrative cost of NGO activities. According to one study, the breakdown of NGO funds is as shown in Table 4.21.[24]

Table 4.21: Expenditure of NGO Funds

Heads of Expenditure	Percentage of NGO Funds Spent on:
Salary and allowances of foreign staff	70
Salary of Bangladeshi staff	15
Office and establishment	10
Spent for the target group (poor)	5
Total	100

Source: Table prepared from information in Syed Serajul Islam, op. cit., p. 64.

It is alarming to note that a paltry amount of 5 percent is spent on the poor people, for whom the donations and funds are really meant in the first place. If this is true, it is really a matter of concern, which probably explains at least partially the dependence of NGOs on foreign donations despite their supposedly high interest income.[25] Besides, complaints have been raised about corruption in the use of NGO funds.[26] It seems that the NGOs are not transparent in the use of their funds and

[24] Syed Serajul Islam, op. cit., p. 64, cited from Nuruzzaman, "NGOs – The Web of Neo Colonialism, Aid Merchant Buying Up Sonar Bangla", *Impact International*, London, July 1994, p. 8.

[25] Several other studies exist in this area. For example, a study compares a government rural development programme, BRDB, with an NGO, BRAC, with respect to cost per member, and finds that the cost per group member in BRAC is Tk. 963 while the same for BRDB is only Tk. 173. See B. Sen, "NGOs in Bangladesh Agriculture: An Exploratory Study". UNDP: *Bangladesh Agriculture Sector Review*, 1988.

[26] Muhammad Enamul Hoque Jalalabadi, *NGO der Shorojontrer Koboley Bangladesh* (Bangladesh Under the Conspiracy of NGOs). Dhaka: Nasima Publications, 1999, p. 270.

accounts, as reflected in a World Bank recommendation, "... NGOs should be fully transparent as to their sources and uses of funds."[27]

1.6 Microcredit to Women and Women Empowerment.

Illiteracy and poverty make women vulnerable in rural Bangladesh. Their status in the family and society is quite miserable. In this scenario, microcredit advanced to women[28] is claimed to have contributed to women empowerment. Access to credit, income generation and the resulting economic role and power have improved the role and status of women in the family and society. The paper under discussion has rightly pointed this out.

This has, however, implications in two dimensions: economic and socio-cultural, which has received very little attention in the paper. The socio-cultural implications will be covered later under the section on the socio-cultural implications of microcredit. On the economic side, some authors question the wisdom of selecting women for microcredit, in order to create job opportunities for women, when the unemployment rate is very high in the country.[29] A question is asked in this context: if the NGOs are sincerely interested in increasing the income of women, why do they not create a situation where the women could work together with their husbands?[30] This means that women get loans for economic activity when men are sitting at home unemployed. Probably this is the reason why in some cases women obtain the loans, which are really spent by men.[31] But, as the loans

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[27] World Bank, op. cit., p. 66.

[28] 549 NGOs deal only with women for microcredit. See World Bank, op. cit., p. 12.

[29] Muhammad Nuruzzaman, *Bangladesh NGO Uponibeshbader Durbheddo Jaley* (Bangladesh in the Web of Creeping Colonialism of NGOs). Dhaka: The Centre for Bangladesh Studies, 1997, p. 40.

[30] Ibid., p. 40.

[31] This is based on informal interviews by the present author (the discussant) with a cross-section of people.

are sanctioned for women, they are the ones who are required to attend weekly meetings and are responsible for repaying the loans. In such cases, women are obviously more vulnerable and are in an embarrassing situation since they do not have control over the money, but they are the ones who are to face the officers and members for repayments. However, in most cases, women seem to use loan money, even if some male members are unemployed in the family, which brings about a change in the power structure in the family, leading to women's empowerment.

1.7 Islamic NGOs

The rural people of Bangladesh are religious and try to follow Islamic values and imperatives in their lives. They have all along rejected *ribā*, except for some hard core poor obtaining loans from moneylenders. Now, with the introduction of microcredit facilities, the entire rural population is becoming trapped in the web of *ribā*, which the Islamists find difficult to swallow. The only feasible alternative in the foreseeable future seems to be the Islamic NGOs and/or the Islamisation of microfinance. Luckily, such Islamic NGOs have already emerged in the recent past.

As mentioned earlier, an important contribution of the paper under discussion is its coverage of Islamic NGOs, which has not been highlighted by other studies. The paper compares Islamic NGOs with secular NGOs in terms of their operation and performance. To us, they are not really comparable, since secular NGOs have a long experience of interest-based operations, while Islamic NGOs are new in their operations using Islamic principles of financing which are new in rural financing, although they follow similar methods of group financing. It could have been useful to allocate more space in the paper to discuss Islamic NGOs, since they have rarely been covered by other studies. It may therefore, be relevant to elaborate here a bit further on Islamic NGOs.

Islamic NGOs have been working for a very long time, from a time when nobody even thought of microcredit in the country. But their activities were confined mainly to adult education, Islamic education, relief work, poverty-alleviation programmes, and so on. Islam-oriented people came forward with microcredit-based Islamic NGOs only recently when the secular NGOs started capturing the entire rural Bangladesh with, according to them, alien values and missionary activities.[32] They have started their operations with Islamic principles of financing very recently, but even then they have created an impact in rural financing on the basis of Islamic principles. As reported in the paper under discussion, the demand for microcredit based on Islamic principles is tremendous, but the resources at the disposal of Islamic NGOs are very limited. While secular NGOs are flooded with resources from foreign sources, both from missionary and neutral agencies, the Islamic NGOs rarely get any outside assistance for providing microfinance to the rural poor. Muslim donors are more interested in relief activities probably because they are not familiar with the benefits of microcredit. It would be useful to launch an awareness drive among Islamic donors about microcredit.

As rightly viewed by the authors, the institution of mosque does already exist in every nook and corner of Bangladesh, which may usefully be used by Islamic NGOs to reach-out for microfinance and as meeting places. If the *'ulamā'*, the Islamists, concerned national leaders and well-off Muslim population of the country work hand in hand, along with external support, the Islamic NGOs may well emerge as a dominant force for poverty alleviation and the preservation of Islamic culture that the Bangladeshi people cherish.

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[32] See Section 3 below for elaboration on this matter.

2. THE LEFTIST APPROACH TOWARDS THE EVALUATION OF MICROCREDIT ACTIVITIES OF NGOs

According to left-oriented activists, the NGOs' approach to poverty alleviation through microcredit and other means is nothing but radical rhetoric without any substance. To them, only a 'radical change in the social structure', and not 'radical rhetoric', can improve the position of the poor.[33] NGOs do not address the structural problems that lie at the roots of poverty but rather, in practice, they work with the existing power structure.[34] Rural development should involve liberating the poor from economic exploitation and social oppression, which does not take place through NGO activities and their microcredit operations.[35] The economic empowerment of the poor, i.e. the "inclusion of the excluded",[36] has not really occurred by the microcredit activities of NGOs. Ahmed Sharif, a renowned leftist intellectual, termed the NGOs as agents of capitalism.[37] Thus, in the left-oriented approach, poverty alleviation requires addressing the issues of rural power structure involving structural changes that will liberate the poor from exploitation by the social elite. This has not been taking place through any of the NGO activities, but rather they seem to maintain and work with the status quo in rural Bangladesh.

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[33] Noore Alam Siddiquee, "Non-governmental Organisations (NGOs) and Rural Development in Bangladesh: A Review of Some Contemporary Questions", *Asian Affairs*, Vol. 17, No. 1, 1995, pp. 46-58.

[34] S. White, "Evaluating the Impact of NGOs in Rural Poverty Alleviation: Bangladesh Country Study", *ODI Working Paper*, cited in Noore Alam Siddiquee, ibid., p. 52.

[35] A. Thomas, "Non-governmental Organisations and the Limits to Empowerment", in M. Wuyts et al. (eds). *Development Policy and Action*. Oxford University Press, 1992.

[36] J. Friedman, *Empowerment: The Politics of Alternative Development*, Cambridge: Blackwell, 1992.

[37] *Daily Sangram*, 3 January, 1996, cited in Muhammad Enamul Hoque Jalalabadi, op. cit., p. 475.

The leftist approach does not however, explain what it means by a 'radical change in social structure', 'liberating the poor from economic exploitation and social oppression', or by 'addressing the issues of rural power structure involving structural changes' in the context of rural Bangladesh. To us, while the desirable structural changes are welcome, any activity that leads to poverty alleviation and improvements in the conditions of the poor, even without a complete restructuring, should also be considered as a welcome effort.

3. SOME SOCIO-CULTURAL IMPLICATIONS OF MICROCREDIT

Microcredit has a number of socio-cultural implications, which have not been covered by the paper under discussion. Some of the implications seem to be quite serious, creating social unrest, tensions and divisions among people. We would like to complement the discussion on microcredit by briefly presenting some of the alleged socio-cultural implications below, since a paper on microcredit without this would be one-sided and incomplete.

3.1 Women Empowerment, Family Relations and Islamic Culture

Let us take the issue of women empowerment through microcredit. It is alleged to have some serious socio-cultural implications. First, it is claimed to have affected family relations and the family power structure by weakening the dominance of the man in the family. The reversal of family dominance or, at least, the installation of women power in the family has been alleged to have affected family relations, leading to family problems in some cases. In these (microcredit) project areas, the husbands often complain that their wives disobey them. They go to meet the NGO officers against their will. As a result, family disputes arise, leading finally to divorces. Then the divorced wives start an offensive against their husbands with the help of other

NGO members, and force them to pay money representing more than their dowries. The NGOs provide free legal aid to women to facilitate divorce. Thus, the divorced women get into a Western culture and lifestyle.

Second, women empowerment through microcredit is also alleged to have produced an effect of Westernisation and cultural de-Islamisation. Rural people are traditionally religious and their women wear *ḥijāb* (the Islamic way of covering the body), and avoid free-mixing with the opposite sex. Most MFIs require members (mostly women) to attend weekly meetings with the officers of MFIs and male members. The women, who have so far been confined to only one male partner (husband), come suddenly into contact and company with other men. The sudden exposure to other men, their close proximity and interaction[38] in the frequent (weekly) meetings may naturally turn on biological feelings towards the opposite sex which, coupled with the affected family relations indicated above, is alleged to create serious complications in family relations, and to damage Islamic socio-cultural values related to dress code and extra-marital relationships. Some of the NGOs distribute condoms and other easily applicable birth control pills free of cost[39] in the name of family planning and female health, which can obviously facilitate a type of relationship that is socially unacceptable in rural Bangladesh.

3.2 Financial Assistance as an Instrument of Missionary Activities, Social Unrest and Politics

It is alleged that some NGOs use financial assistance as an instrument of their missionary activities, to convert the poor to

[38] Women sit with men in the meetings, speak and interact with them. Their activities, interaction and participation in the meetings with men are highly encouraged to develop confidence in them for the achievement of women empowerment.
[39] Muhammad Enamul Hoque Jalalabadi, op. cit., p. 94.

Christianity, both non-Muslim and Muslim.[40] It has been reported that literature on the superiority of Christianity over Islam,[41] which distorts Islamic beliefs, is distributed to members of the NGOs, and that many people have been converted to Christianity, including some Muslims. Such activities, along with the alleged de-Islamisation effect of women participation has created serious concerns among the Muslim population, which have been reflected in protests, demonstrations, and large gatherings.[42] The report of 25 Muslims converting to Christianity in the Cox's Bazaar area led to serious tension and unrest in the area, including protest meetings, strikes, street demonstrations, clashes with police, arrests and so on.[43] This has caused worries for the government, too. "Government officials are sometimes worried that foreign funds may be used for 'anti-national' and/or 'anti-social' activities. These worries span the spectrum from armed insurgency to religious proselytisation."[44] Accordingly, the government was forced to investigate the activities of the NGOs, which led to the banning of some of them. But the government was forced to re-install them within a short period of time due to outside pressure.[45] Several books and

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[40] Quite a number of NGOs are said to be involved in missionary activities in the name of relief and poverty-alleviation programmes. Among those directly involved in such activities are CARITAS, Baptist Missionary Society, Baptist Aid Mission, Christian Reformed Relief Committee, Mennonite Central Committee, Missionaries of Charity, Rangpur-Dinajpur Rural Service, Bangladesh Lutheran Mission, Finish, and so on. See Muhammad Enamul Hoque Jalalabadi, op. cit., p. 263.

[41] For example, raising such questions as this: when Islam's Prophet is unable to save even his daughter, Fatimah, then he cannot intercede for believers to save them on the Day of Judgement. See Muhammad Nuruzzaman, *Bangladesh NGO Uponibeshbader Durbheddo Jaley*, op. cit., p. 44.

[42] For example, a huge gathering of people was held in Manik Mia Avenue, which was addressed by many national figures. See the *Daily Sangram*, 1 May 1996, cited in Muhammad Enamul Hoque Jalalabadi, op. cit., pp. 475-476.

[43] *Daily Sangram*, 24 October, 1992, cited in Muhammad Enamul Hoque Jalalabadi, op. cit., pp. 442-443.

[44] World Bank, op. cit., p. 46.

[45] Syed Serajul Islam, op. cit., pp. 65-66.

booklets have been written to expose the missionary activities of the relevant NGOs, but the affected NGO members do not have access to such literature.[46] Many features have been published in some concerned national dailies,[47] but the powerful NGOs care very little about them.

It should be mentioned here that not all NGOs are involved in missionary activities, and some NGOs who are directly involved in missionary activities are not involved in microcredit, although some missionary NGOs may well be involved in microcredit operations, too. However, public opinion seems to have gone against NGOs in general due probably to the serious concerns about some NGO activities.

For the reasons mentioned above, Islamist groups and other concerned people have been against the missionary activities of NGOs, which created a cold war between them and such NGOs in general. This enmity has been transmitted to national political elections, too. According to some political analysts, the NGOs played an important role in causing the poor performance of the Islamic parties in the last election. The campaign and propaganda by dominant NGOs that 'loans will be stopped if the Islamist groups come to power', and that 'the Islamic groups will stop women from coming out of their homes', etc., worked against Islamic groups.[48] In particular, some NGOs have been alleged to have tactfully, and sometimes forcefully, manipulated women voters to cast their votes

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[46] For example, Muhammad Enamul Hoque Jalalabadi, op. cit., 1999, and Muhammad Nuruzzaman, *Bangladesh NGO Uponibeshbader Durbheddo Jaley*, op. cit., 1997.

[47] See for example, (1) *Daily Inqilab*, 5 August 1996; (2) *Daily Sangram*, 9, 13, 14, 28 April 1994, 16 May 1994, 28 November 1997, October 1995, 23 July 1998; (3) *Daily Bhorer Kagaj*, 7 July 1992; (4) *Daily Dinkal*, 25 October 1996; (5) *Daily Millat*, 30 July 1997, cited in Muhammad Enamul Hoque Jalalabadi, op. cit., pp. 440-486.

[48] See Muhammad Enamul Hoque Jalalabadi, op. cit., pp. 356-361; and the *Daily Sangram*, 28 June 1996, and other news reports, as quoted in their books by Muhammad Enamul Hoque Jalalabadi, op. cit., 1999, and Muhammad Nuruzzaman, *Bangladesh NGO Uponibeshbader Durbheddo Jaley*, op. cit., 1997.

in favour of secularist candidates who would support their de-Islamising activities.[49] Some political analysts have considered this to be an important cause behind the poor performance of Islamic groups in the last elections.[50]

These are some of the socio-cultural implications of some NGO activities dealing with financial assistance, poverty-alleviation projects and, probably with some microcredit activities, which have produced serious concerns among the *'ulamā'*, Islam-loving people, and a number of social leaders.

4. CONCLUDING REMARKS

The paper under discussion describes NGO activities in Bangladesh, even though partially. An important contribution of the paper is the discussion on Islamic NGOs, although it would have been useful to allocate more space to this. The paper mainly discussed the positive aspects of microcredit. It cannot be denied that MFIs have contributed to income growth of the members, despite many alleged negative effects of microcredit activities. An attempt has been made here to complement the paper by briefly discussing some of the alleged negative effects of microcredit;[51] not to undermine the

[49] For example, it was reported in a national daily that a woman in her advanced stage of pregnancy was forced by an NGO to come to the polling centre to cast her vote for its candidate, but she could not cast her vote and, instead, she gave birth in the polling centre. This led to social unrest in the area. See *Daily Sangram*, December 5, 1997, cited in Muhammad Enamul Hoque Jalalabadi, op. cit., p. 279.

[50] Ibid., pp. 356-361.

[51] It is to be noted here that the negative effects and, especially, negative socio-cultural effects have not been formally verified by this discussant. The discussions here are based mostly on secondary materials and some informal interviews, which have been presented here at least to highlight some of the concerns on the issue. However, without even any verification of the facts, it is quite obvious and visible that a large section of people are concerned about the situation, as reflected in protest meetings, gatherings, literature; and also in frequently appearing features in national dailies, both for and against.

achievements of microcredit, but to present both sides of the picture for the sake of completeness.

Microcredit can be made an important instrument of poverty alleviation, provided the MFIs dedicate themselves to poverty alleviation through microfinance with full sincerity, proper fund management, accountability and transparency, without getting involved in any activity that creates social unrest, tensions, and divisions among the people. There should be a high-powered Supervisory Body to oversee the activities of MFIs so that they do not and cannot become involved in activities that affect the religious sentiments of the people and create socio-cultural problems, unrest and tension. Such a body should also have the authority to supervise the sources and uses of their funds. Islamic NGOs would also be able to make good contributions, if the needed support is provided to them, both from internal and external sources, as is the case for secular NGOs.

CHAPTER 5

The Elimination of *Ribā*: A Measure Truly Dedicated to Poverty Alleviation

*Seif el Din I. Tag el Din**

1. INTRODUCTION

The challenging message that has been well delivered over the last three decades by the Islamic financial industry is the proposition that financing and investment is possible without imposing an interest rate. While we unquestionably endorse the juristic consensus that fixed interest on money capital falls under the purview of forbidden *ribā*, our main objective in this study is to emphasise the ethical mission of *ribā* elimination as a measure dedicated to poverty alleviation in the context of distributive justice. The main analytical drift is to explore the complementarity of the two types of *ribā*: loan *ribā* and *al-faḍl ribā*, respectively, as curative and preventive measures for the attainment of a just economic order. In particular, the *irfāq* (philanthropic) sector is established as the ethical foundation without which the mechanical removal of interest

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rate may not necessarily yield favourable consequences in the distributional context. The idea that removal of interest rate is an integral part of a strategy for distributional justice is not uncommon among Islamic economists,[1] but little attention, thus far, has been directed to develop the ethical implications of this issue. The concern in current literature with the ethical implications of *ribā* elimination seem to have been neglected due to the greater emphasis on the financial technology of interest- free finance.

The understanding that *ribā* is an economic evil leading to human impoverishment and the concentration of wealth in a few hands is generally upheld, not only by Islamic scholars but equally by the other revealed religions and almost all human cultures. In this sense, a successful *ribā* elimination strategy must yield a re-distributional effect in favour of the least fortunate and poverty stricken masses, but this is lacking in Islamisation (or interest removal) schemes that were initiated more than two decades ago. Official statistics for one of the few full-fledged interest removal schemes, reveal an extremely disappointing result over the last decade: a sweeping re-distributional effect in favour of the wealthier class, leaving more than 90 percent of the population below the poverty line which is too ironical indeed.[2]

This may partly justify an air of mixed feelings, if not scepticism, among the Muslim public about the true economic mission of interest rate removal. In fact, the appeal of juristically approved modes of finance (for example, *murābaḥah, istiṣnā*ʿ, etc.) becomes questionable when the 'profit rate' under Islamic banking seems to exceed the forbidden interest rate. Such anomalies tend to provoke an unpopular viewpoint which attempts to differentiate between the modern banking interest rate and forbidden *ribā*, mainly on the presumption

[1] For example, see Chapra (2000). However, we differ with Chapra in that humanitarian goals and equitable distribution of income can be fulfilled within the market set-up by simply replacing the interest rate system by a profit-sharing system.
[2] Release by Centre of Strategic Studies, Khartoum, Sudan, to the national press (1997).

that *ribā*, unlike the modern interest rate, was an exploitative transaction between a weak borrower for a desperate human need (for example, food) and a strong wealthy lender.[3] The idea is that a desperately needy person needs charity rather than a high interest loan, a point which is often argued with reference to the Qur'ānic verse: "*Allah will deprive usury of all blessing, but will give increase for deeds of charity*" [2:276]. While it is obvious that this Qur'ānic verse underlies some analytical link between *ribā* prohibition and the giving of charity, such a link cannot be taken to imply an exploitative transaction between a desperate and weak borrower and a strong lender. As argued below, this Qur'ānic verse provides the ethical foundation of *ribā* elimination, which is the promotion of the *irfāq* sector.

1.2 Our Methodological Approach

To gain analytical clarity, we shall depart from the three interdependent focal problems of economic organisation: *what? how?* and *for whom to produce?* The idea is that if *ribā* elimination is a well focused economic measure, which we hold to be the case, then it must primarily address one and only one of the three focal problems, apart from any secondary reactions or indirect implications. Since the three focal problems make it possible to identify any given economic system as a product of three interdependent primary strategies, production, technology, and distribution, our main problem is to assign *ribā* elimination to one of these primary strategies. As expected, our enquiry ends up with the result that *ribā* elimination is a measure supportive of the distributional strategy addressing the focal question, for whom to produce, rather than being supportive of the technological strategy addressing the question how to produce, though the latter appears to command undue emphasis in the current

[3] For a detailed account of this trend see Saeed (1999), who adopts the same view.

literature. We shall also exploit the standard implication of the Law of Scarcity, that each of the three focal problems must involve an economic choice problem between alternative uses of a given scarce resource, and, hence, *sacrifice* of the foregone alternatives. Given that the distributional strategy entails a non-market curative function, as we shall shortly explain, the relevant element of sacrifice will be a *sacrifice of self interest*. By contrast, the relevant element of sacrifice in relation to the focal question (how to produce?) is one of a purely technical nature within the market set-up, which means, in principle, that the technology of interest rate finance can hardly meet the curative function of a distributional strategy.

For sure, our intention is not to underrate the current research emphasis on the business driven enquiry on the technology of interest-free finance. Naturally, it is an imperative consequence of *ribā* elimination that Muslim producers have to seek alternative modes of financing to support the growth process. It is indeed an interesting finding that profit-sharing (*muḍārabah*) embodies an optimal property of risk sharing which is lacking in interest-based finance.[4] Yet we believe that profit-sharing cannot be dwelled upon as the strategic objective of *ribā* elimination, since it is a technical choice within the market sector, involving no distributional sacrifice.

2. DISTRIBUTIONAL STRATEGIES: BASIC FUNCTIONS AND MEASURES

To avoid getting into a philosophical controversy on the concept of distributional justice, we shall take any non-market intervention for relieving human impoverishment or misfortunes to be a measure of distributional strategy. On this basis, we can identify two basic functions of any distributional strategy:

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[4] Different optimal properties of profit-sharing are discussed in Khan and Mirakhor (1987).

1. **Curative Function:** this relates to non-market resource allocation measures targeted towards the attainment of certain social goals that cannot be met through the market mechanism. The key word for this function is a non-utilitarianist force (for example, government authority) that imposes a distributional sacrifice on the public, and, hence, mobilises resources through taxation, confiscation, or any alternative measure, to finance the targeted social goals. In case of the *irfāq* sector the element of *distributional sacrifice* becomes built in within the social behavioural fabric. Thus, the crux of the matter is whether sacrifice is a matter of free economic choice, as under the Islamic *irfāq* sector, or one that is enforced exogenously through government power.

2. **Preventive Function**: it covers two main arms of regulatory measures: (i) market regulatory measures, and (ii) monetary regulatory measures. The former ensure a sufficiently competitive market, with a view to protecting consumers from the possible emergence of monopolistic powers, and maintaining employment levels. The latter ensure a monetary policy that cares for public interest rather than private vested interests. However, we shall ignore the latter since the complexities of monetary policy require an independent treatment of its own. And since the *pricing property* of *ribā al-faḍl* (the rules for gold/silver) relates to monetary policy, this will also be ignored. The idea is to associate the elimination of loan *ribā* with the curative function, in the sense of promoting an effective *irfāq* sector, and to associate the elimination of *ribā al-faḍl* with the preventive function in relation to anti-monopoly measures.

2.1 Secular Versus Islamic Strategies

To distinguish secular distributional strategies (socialist/capitalist) from their Islamic counterpart, the nature of *non-utilitarianist force* is the key factor. The great difference in the extent of corrective measures adopted by the socialist, as opposed to capitalist distributional

strategy, underlies the same approach, which is recourse to government authority as the instrumental non-utilitarianist force. Yet, we believe that the effectiveness of any distributional strategy in the long term depends on the nature of the non-utilitarianist force rather than the extent of state supported measures, and this is how the Islamic distributional strategy differs from secular ones. The projection of the Islamic economy as a mid way between the extremes of capitalism and socialism (a concept that used to dominate during the Cold War period) focused only on the *extent* of state intervention, thus failing to make a genuine distinction between the Islamic system and the mixed capitalist system.

Radical socialism over-emphasises the curative function through a centrally planned system and displaces the allocative function of free markets. Also, it over-emphasises the preventive function through banning individual ownership for productive instruments. Exchange in the centrally planned system is carried out through an extremely regulated market, acting merely as a clearance mechanism to realise the central plan targets. Free market capitalism, on the other extreme, upholds a distributional strategy that relies heavily on the power of free competitive markets with minimal non-market authority. Developed free market countries are characterised by a mixed system. The mixed system in the developed world was an effort to strike a balance between the competitive market's power and an ambitious social insurance sector under government control. As it appears, earlier founders of radical socialism failed to anticipate how a self corrective flexibility in free market systems might significantly improve the 19th century's vulgar capitalism and project a humanitarian face on capitalism. Nonetheless, recent experience reveals how governments, having laboured heavily under large budgetary burdens, rising deficits, and inflationary pressures, can hardly maintain the state supported social insurance order for long. The dramatic collapse of radical socialism cannot be isolated from a similar foreseeable fate of the 'welfare state' in the developed free

market world, though in a gradual manner. Spearheaded by industrial multinationals, globalisation has already weakened governmental grip and initiative in the market place in both developed and underdeveloped nations. Financial deregulation and public sector privatisation are the two main forces that tend to shape a new world not too far apart from the 19th-century's vulgar capitalism. The warning that mixed economies are steadily degenerating into 19th century capitalism is commonly voiced in the industrially developed world, most remarkably by Greider (1987). Whereas the collapse of the mixed capitalist system may not come as a dramatic shock like the collapse of radical socialism, the fact is that both distributional strategies failed to effectively sustain a humanistic concept of distributional justice beyond a relatively brief period in human history.

On the other hand, the Islamic distributional strategy develops its key non-utilitarianist force as a built in property within the social behavioural fabric. This humanistic factor is sharply focused by Qur'ānic and Sunnite teachings addressing the inner human conscience to create a free civil society of mutually caring individuals. The *irfāq* sector, thus, emerged as a forceful reality during the Prophet's lifetime (peace be upon him), and continued to flourish as a deep seated social insurance order, consisting of *waqf* (charitable foundations) and other vehicles of voluntary giving, till the late historical stages of the Islamic state. Al-Zarqa (1984) provides a detailed account of *irfāq* tools that used to characterise the Islamic economic system. Even in non-Muslim societies an *irfāq* sector of some sort, based on religious norms, used to play an effective economic role in earlier societies. Unfortunately, however, we may fail to appreciate the historical role that *irfāq* sectors used to play in the distant past, since we are unable to perceive the extent of structural change that human societies have undergone over the last century. Becker (1996) recognises this fact by pointing out: "charity is a form of insurance that is a substitute of market insurance and government

transfers. Presumably, the rapid growth of the latter during the last 100 years discouraged the growth of charity". Nonetheless, currently rising concerns with philanthropy in the West is a definite recognition of the fact that a stable social insurance system has to be deeply rooted in humanistic civil values rather than precarious state supported systems.

The Islamic approach is to directly build the necessary philanthropic values in human behaviour to help establish the *irfāq* sector upon the free economic choice of the members of a society. In fact we can think of the relevant Qur'ānic and Sunnite teachings as a complete package of human resource development setting forth the development of favourable attitudes, not only towards the productive strategy but also towards the distributional strategy. Interestingly, even where the focus is placed on productivity growth, it can be shown that higher growth targets are achievable through a human resource programme that simultaneously promotes technical productivity norms and ethical equity distributional norms. [See Tag el Din (1997).] In this sense, the active performance of the *irfāq* sector can give room to a healthy intermarriage for both growth and equity. Yet, all secular systems ignore human resource development in relation to the distributional strategy. The radical socialist system resolved all the three focal strategies (production, technology, and distribution) through the exogenous choice of Central Planner. While free market democracies allow for free economic choice in production and technology strategies, the distributional strategy cannot be based on free economic choice due to the lack of a necessary human resource basis. Recourse to government power is justified by the fact that free economic choice by individual agents cannot provide the key non-utilitarianist force, specifically where distributional *sacrifice* is alien to the social behavioural fabric. Perhaps, the current trend to associate philanthropy with democratic participation is to address such anomalies in the Western free market systems.

2.2 Philanthropy and Participating Democracy

Increasing concern with patterns of giving and voluntarism by different religions, ethnic, racial, gender, and economic groups, has led to the establishment in New York in 1986 of the Centre for the Study of Philanthropy, in order to provide a going forum for research, discussion and public education on philanthropic trends. Such researches are built around the underlying hypothesis that: *philanthropy holds the key to understanding the working of participatory democracy and civil society.*[5] Interestingly, the *Harvard Business Review*[6] reveals the fact that the number of charitable foundations in the US has doubled over the last two decades while the value of their assets has grown by more than 1,100 percent. Although statistics are lacking in Muslim nations, we should expect an even stronger trend.[7]

3. *RIBĀ* ELIMINATION: THE CURATIVE FUNCTION

As previously outlined, our aim is to show how the elimination of interest rate (loan *ribā*) and the banning of *ribā al-faḍl* contribute to the curative function and preventive function, respectively, of the Islamic strategy. To see the resource allocative nature of loan *ribā* elimination as a curative measure, we must appreciate the fact that the *irfāq* sector cannot function as an effective social insurance order without the supportive service of a *resource allocative measure* on a permanent basis.

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[5] Internet Website: www.philanthropy.org

[6] Internet Website: www.hbsp.harvard.edu, book by Michael E. Porter and M. E. Kramer – titled *Philanthropy's New Agenda: Creating Value.*

[7] Two main factors account for this point. First, that Muslims' culture is philanthropic in nature. Second, the fact that the stage of economic development in most Muslim countries is one where philanthropic traditions still prevail, particularly in vast rural sectors where the traditions of extended family ties are strongly established.

The basic idea is that, since there are competing alternative uses for any scarce resource, the financing of the *irfāq* sector must be met by shifting resources away from alternative uses. More specifically, it is needed to bear a *distributional sacrifice* by releasing resources, on a permanent basis, away from strictly utilitarianist dealings to strictly non-utilitarianist dealings. That is, from *ribā* transactions in money markets, to the financing of pressing human needs in the *irfāq* sector. Indeed, this is the basic idea to be learned from the Qur'ānic verse *"Allah will deprive usury of all blessing, but will give increase for deeds of charity"* [2:276], since it highlights two alternative uses, namely *ribā* taking and charity giving, of the same economic resource. The same resource re-allocative function is shown even more explicitly in the verse: *"That which ye lay out for increase through the property of (other) people, will have no increase with Allah: but that which ye lay out for charity, seeking the Countenance of Allah, (will increase): it is these who will get a recompense multiplied"* [30:39]. This verse clearly calls for the bearing of distributional sacrifice by shifting resources from return prospects within borrowers' property to the financing of charitable targets. On this basis, the juristic rule that moneylending is a specialised *irfāq* transaction should be taken as an indication that the banning of *ribā* is intended to provide support for an existing *irfāq* sector. As regards the Qur'ānic verse that *"Allah permits trade and prohibits* ribā*"*[2:275] , it is obviously not an indication that market sale is more equipped to bear distributional sacrifice than *ribā* lending. It only implies that sale is a permissible activity. It cannot be forbidden like *ribā*, since life cannot go on without it.

As it seems, there is an implicit juristic implication that restricted *utilitarianist* uses invoke resource re-allocation to non-*utilitarianist* uses. In fact, when an active *irfāq* sector already functions as a forceful reality, it requires little analytical effort to understand the intent of restricted *utilitarianist* use of an otherwise valuable economic asset. In such a context, people would automatically understand that they

must dispense with such an asset for the *irfāq* sector. The best example for this spontaneous behaviour is the Prophet's *ḥadīth* that at one time prohibited the eating of *sacrificial* meat beyond three days.[8] That was a time when travellers in a large caravan, who were too short of food, passed across Madinah on their long travels. Acting within the Islamic social value system, and further exhorted by the Prophet's *ḥadīth* not to keep sacrificial meat beyond three days, the people of Madinah automatically dispensed of the remaining meat to the passing caravans. However, since the Prophet's Companions were literally abiding by his *ḥadīth* at all times, some of them continued to dispense of the sacrificial meat beyond three days, even in later years. Eventually, the Prophet was directly asked to explain his specific intent at the time of the passing caravan. The point is that the banning of *ribā* should invoke a similar reaction if an active *irfāq* sector already exists, but when the social value system is too utilitarianist, the banning of *ribā* becomes paradoxical.

3.1 *Ribā* Paradox and the Obvious Resolution

To further substantiate the above conclusion, let us highlight the paradoxical case of *ribā* elimination within a strictly utilitarianist environment consisting only of a market sector. The pure market sector is assumed to consist of goods' market and capital market where lending/borrowing takes place. The idea is to derive the implications of *ribā* elimination within such a set-up and see how impoverished individuals can be dealt with. We shall take the case of a poor unemployed worker who must immediately buy medicine for his seriously sick child. Within the strictly utilitarianist set up, all economic agents are utility/profit maximising. Hence, this desperate

[8] The *ḥadīth*, which prohibits eating of sacrificial meat, is reported by Muslim in three versions. See numbers 1258, 1259, 1260 (pages 340-341) of *Mukhtaṣar Ṣaḥīḥ Muslim* edited by Muḥammad Nāsir al-Albānī; al-Maktabah al-Islāmīyah, Beirut, Damascus, 46th edition (1982).

worker can only do one of two things: buy the medicine at credit from any nearby chemist if possible, or alternatively borrow money from any moneylender, to buy the required medicine. However, the second option is forbidden *ribā*, but the first option is juristically permissible because it is a sale of a good with mutual consent. Incidentally, no chemist would be juristically blamed for refusing to sell the needed medicine to this worker at the desired credit. Of course, the poor worker would not resort to money borrowing if he could get the needed medicine on credit. Given that money for the poor is nothing more than a means to buy needed goods, the poor would never resort to borrowing if sale at credit was assured in the first place. Yet, paradoxically enough, he is not allowed to solve his problem by borrowing at an interest rate, even where it is equal to the credit cost associated with the deferred price. Ironically, if lenders offer the needed credit under the assumed environment, they should be labelled as more humane than medicine sellers who were heedless in the first place to the worker's need. This point raises the paradoxical question: how can we hold sellers faultless while we stigmatise lenders on *ribā* as inhumane and exploitative, although the opposite seems to be true? This paradox highlights two main points: first, that *ribā* elimination within a strictly utilitarianist model cannot play any distributional role, even if profit-sharing or any alternative mode is used. Second, the evil of *ribā* is not simply attributable to the exploitation of borrowers by lenders, even if the borrowing party is as weak and desperately poor as the unemployed worker in our example. Contrary to this proposition, *ribā* based loans seem to offer a valuable service within a strictly utilitarianist model!

We are presenting this dramatic example to highlight a *ribā paradox* which underlies current mixed feelings on the rationale of interest rate elimination. Yet, like common economic paradoxes it must have an obvious resolution, which is simply the fact that capital markets cannot allow our desperate worker to borrow the needed money. Our worker's problem cannot be solved within a strictly utilitarianist market context,

whether it is credit sale or borrowing money. Given that lenders wish to secure fixed returns rather than entertain severe loss from defaulted borrowers, our worker can have access to the capital market only if he misleads moneylenders with false information about himself. However, modern capital markets have attained such a level of transparency and organisational efficiency that non-trustworthy borrowers are easily discovered and promptly dismissed at the screening stage. Accordingly, our worker's problem can only be settled through payment of government transfer or charity. The introduction of a non-*utilitarianist* force, either through government interference or the *irfāq* sector, becomes essential to resolve our worker's problem. Given the Islamic distributional strategy, it is only then that *ribā* elimination makes sense as a means to release resources to finance *irfāq* needs.

4. *RIBĀ* ELIMINATION: THE PREVENTIVE FUNCTION

Now, we shall consider the role of *ribā* elimination with reference to the preventive function of distributional strategy, namely *market regulatory measures* to guard against harmful monopolistic tendencies. We should first provide the juristic definition of *ribā al-faḍl* before we demonstrate the nature of its subtle monopolistic mechanism. It is worth noting that guarding against harmful monopoly in Islamic jurisprudence is not only expressed directly through explicit measures, but also indirectly through implicit measures. In his study of the monopoly concept under Islamic jurisprudence, al-Dūrī (1974) mentions the Prophet's prohibition of meeting trade caravans before they reach the marketplace as an implicit preventive measure, among a few other measures. In this sense, we believe that the prohibition of *ribā al-faḍl* is among such implicit preventive measures. Hence, we employ some useful insights in al-Ghazālī's perception of *ribā al-faḍl*, and reinforce it through an analytical model.

4.1 *Ribā al-faḍl* in Islamic Jurisprudence

The bases of *ribā al-faḍl* prohibition are several authentic *aḥādīth* of which one states: gold for gold, silver for silver, dates for dates, salt for salt, wheat for wheat, and barley for barley: same for same, hand to hand. Whoever gives more or asks for more, is making *ribā*.[9] The essence of *ribā al-faḍl* prohibition is that homogeneous items, among the above six items, should only be exchanged in equal quantities. Thus, it is impermissible to exchange more units of an item for less units of the same item due to difference in quality. For example exchanging two units of low quality dates for one unit of high quality dates is an act of forbidden *ribā al-faḍl*. However, the jurisprudence of *ribā al-faḍl* remained a controversial issue as scholars differed widely on the common property or properties that characterise the above-mentioned six items, in order to extend their scope to other similar goods. The Ḥanafī School, and a minority of the Ḥanbalī School, regarded *weight* (for gold and silver) and physical *volume* (for dates, salt, wheat and barley) as the two main properties.[10] Hence, according to the Ḥanafī School all goods that can be measured by weight or volume should also be subjected to the prohibition of *ribā al-faḍl*. However, the other three Schools, Mālikī, Shāfiʿī, and the majority of the Ḥanbalī School, all agree on two properties, namely *pricing* property (for gold and silver) and *feeding* property (for dates, salt, wheat, and barley). There is still a fine difference between Mālikī and Shāfiʿī on how feeding property is defined. The Mālikī School accommodates only storable, and staple food, but the Shāfiʿī School adopts a much broader range of edible items including

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[9] See number 949 in the reference in footnote (8) above.

[10] The Ḥanafī position is explained by Kāsānī in his book *Badāʾiʿ Al-Ṣanāʾiʿ* (p. 138), while that of the Ḥanbalī position is explained by Ibn Qudāmah in his book *Al-Mughnī*, (pp. 105-106). The Shāfiʿi position, as regards the kind of food on which *ribā al-faḍl* in defined, is explained by *Al-Majmūʿ Sharḥ Al-Muhadhdhab* (p. 397), while that of the Mālikī School is explained in *Al-Mudawwanah Al-Kubrā* (p. 162).

fresh fruits of all kinds, medicine, etc. In this section, we shall adopt the dominant juristic view of the three schools, with the Mālikī view on feeding property that we find more relevant to the economics of *ribā al-faḍl*. The Mālikī position has the additional merit that it is accepted by prominent scholars in the Shāfiʿī and Ḥanbalī Schools, namely al-Ghazālī and Ibn al-Qayyim. Thus, we shall only consider 'feeding property' in relation to staple and storable food.

4.2 'Feeding Property' and the Case for Harmful Monopoly

Given the Mālikī expression of 'feeding property' the obvious economic question is: why bother at all with storable staple food? In the first place, if such food is available in sufficient supplies and reasonable prices to satisfy demand, there should be nothing to bother about. It is usually the problem of food shortage that is of paramount importance, whenever issues of feeding are raised. If we ignore natural calamities, food shortages are created through monopolistic practices, where profiteering suppliers are tempted to build up stocks of high demand *storable* food items to influence market prices and make large profits. The potential damage becomes even more serious when shortages are created in a staple food, in order to capitalise on its low demand elasticity. Thus, apart from any further considerations (to be shortly elaborated), common sense would associate harmful monopolistic practices with the Mālikī 'feeding property' of *ribā al-faḍl*.

Other alternative explanations of *ribā al-faḍl* that exist in the received literature do not seem to fit with the critical implications of 'feeding property'. Al-Jazīrī in his book *al-Fiqh ʿala al-Madhāhib al-Arbaʿah*, suggests *serious gharar* as the damage that explains the prohibition of *ribā al-faḍl*.[11] The idea is that inexperienced people can easily be cheated about the true quality of goods when they

[11] See al-Jazīrī, Abdul Raḥmān, p. 247.

exchange more of a low quality good for less of a high quality good. It is, hence, believed that people are advised to introduce a *medium of exchange* to sell low quality goods at a price and then buy the high quality goods. This theory is argued with reference to the well-known *ḥadīth* in which the Prophet (peace be upon him) prevented the owner of low quality dates, say Party B, from exchanging with the owner of high quality dates, say Party A, two units of low quality dates (*jamʿ*) for one unit of high quality dates (*janīb*).[12] He advised Party B to first sell low quality dates to a third party, say Party C, at any price (may be a different commodity), and then use such a price for buying high quality dates from Party A. In our subsequent discussion we shall utilise this three party model (A, B, C), but as regards the theory of avoidance of serious *gharar* we believe it cannot embody the juristic intent of *ribā al-faḍl* elimination for the following reasons:

1. In principle, the introduction of a *medium of exchange* may aggravate the alleged problem of *gharar* rather than resolve it. If Party B is inexperienced about quality, he would be better off when directly exchanging the two qualities with Party A, than indirectly through selling a low quality good at a price to Party C and then using the money to buy from Party A. In this case, he would be exposed twice to the possibility of cheating: first, the possibility of under payment by Party C when selling a low quality to him, and second, the possibility of over payment to Party A when buying the high quality from him.
2. In an authentic *ḥadīth*[13] one of the Prophet's Companions, acting as Party B, expressed his awareness about the two market prices of the *low* and *high* qualities, but the Prophet

[12] See *Mukhtaṣar Ṣaḥīḥ Muslim*, by M. Nāsir al-Albānī, Ḥadīth No. (913), p. 246.
[13] Ibid., No. 954.

(peace be upon him) still did not allow him to exchange more for less. It follows that lack of experience in quality is not the reason behind the prohibition.

3. *Gharar* is tolerated in Islamic jurisprudence when it is not too serious. At any rate, the possible *gharar* in the direct exchange of different qualities cannot be as much as that of exchanging *dry dates* against their rough equivalent of *fresh date* bundles still on palm trees (*bayʿ al-ʿarāyā*), which is nonetheless permitted in the Sharīʿah.

4.3 Insight from Al-Ghazālī and Ibn al-Qayyim

The question of juristic intent in relation to *ribā al-faḍl* prohibition has remained an unresolved issue, as admitted by al-Shāṭibī.[14] Among contemporary efforts to rationalise the prohibition of *ribā al-faḍl*, is Safieldin's contribution (1974) in which he attributed pricing property to all six items of *ribā al-faḍl*. Yet, Safieldin has lately given up his belief that *pricing property* is the common rational for all six items mentioned in the *ḥadīth*. Fortunately, however, there are valuable indications from the works of Abū Ḥamid al-Ghazālī and Ibn al-Qayyim that can be built upon to establish a consistent vision on the economics of the prohibition of *ribā al-faḍl*. Al-Ghazālī makes an explicit statement on the evils of monopoly in food items in *ribā al-faḍl* and explicitly associates a monopolistic motive with *ribā al-faḍl* in food items. He opines:

> "...[Food] should not be swayed away from its feeding purpose. If the door were made open for dealing in food this would restrict its circulation in the hands [of dealers] and impede its way to consumption, which is the purpose for food. Need for food is so pressing that it should be directly transferred from the hand of non-demander to the hand of demander ... and if traded it should be sold

[14] al-Shāṭibī, Vol. 4, p. 31.

> directly to one who demands it for consumption. Yet, he who sells food in exchange for the same food cannot be a demander of food. For this reason monopoly is denounced in the Sharīʿah." [*Iḥyā' ʿUlūm al-Dīn*, Vol. IV, pp. 121-122].

Ibn al-Qayyim regards the trade profit motive as the main trigger for receiving *ribā al-faḍl*. He associates *ribā al-faḍl* with *immediate profit* and *ribā al-nasa'* with *postponed profit*. In this sense he agrees with al-Ghazālī's view that the receiver of *ribā al-faḍl* acts under a *profit motive*. Specifically, he says:

> "If it were allowed to exchange food items against each other for delayed delivery, this is only done by one who seeks profit. Then, [at the delivery time], he would sell it spot for the sake of profit, thereby causing food shortages and serious damage to consumers… Thus, *ribā al-nasa'* was banned, and accordingly, *ribā al-faḍl* was prevented *prudentially*, such that the temptation of *immediate profit* (*ribā al-faḍl*) would not induce people to the *postponed* profit (*ribā al-nasa'*)."[15] [*Iʿlām Al-Muwaqqiʿīn*, Vol. 2, pp. 136-138.]

It is clear from these quotations that both scholars agree that Party A (within the above three parties' model) is excluded from dealing in low quality dates because of his potential trade motive, a point that makes good economic sense. On this basis, we argue that the exclusion of Party A is a measure of prudential prevention (*sadd al-dharā'iʿ*) against a possible monopolistic practice. The gist of the matter, as we see it, is that there is deliberate intent to exclude Party A due to his potential harmful practice in the foods market, and to include Party C due to his considered demand for food.

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[15] Ibn al-Qayyim's distinction between the two kinds of profit is highly questionable. However, what concerns us here is that he is explicitly attributing the trade profit motive to *ribā al-faḍl*.

4.4 The Status of Party C and the Juristic Intent

It would appear on reflection, that the third party (Party C) is the decisive factor, since Party C was deliberately introduced by the Prophet himself (peace be upon him) in order to correct the *forbidden transaction*. Hence, the juristic intent of *ribā al-faḍl* prohibition is best revealed by contrasting the most likely motive of the excluded party (Party A) as opposed to the introduced party (Party C). We have already seen from the analysis of al-Ghazālī/Ibn al-Qayyim, that it is the profit motive that mostly characterises Party A. Hence, the rest of the analysis is only to ask the critical question*: what is the rationale for introducing Party C?*

To address this question we should depart from the economic premise that there is bound to be very high demand for low quality dates among low-income masses, who are normally much larger in number than high-income groups. Incidentally, low quality dates (*jamʿ*) was the usual food of the Prophet (peace be upon him) as he was always keen to maintain a humble living like the low income masses. This economic premise should give rise to high profit temptations in low quality food trade. There is yet another premise: that food buyers for consumption purposes are much larger in number than food sellers. Hence, the rationale for introducing Party C must relate to the most likely fact that Party C needs to satisfy his need for food, while Party A is excluded due to his potential harmful practice in the food trade. Accordingly, we must dismiss the alternative answer that *Party C is introduced as a means to eliminate* ribā al-faḍl: this answer treats the prohibition of *ribā al-faḍl* as an end in itself rather than as a means to protect the market from some harmful practice. But if Party C has successfully satisfied his need for food, then, this in itself, is a legal end. The correct statement must, therefore, be that the elimination of *ribā al-faḍl* is a means to satisfy Party C's needs.

At the same stroke, we should dismiss the alternative answer that *Party C is a means to provide a needed price for Party B.* This is also unacceptable due to the established juristic intent that 'necessities command a higher priority as compared to luxuries'. In this sense Party C is a purchaser of a basic necessity good (low quality dates), while Party B is a purchaser of a luxury good (high quality dates). Hence, from the viewpoint of juristic intents, Party C's purchase commands a higher juristic priority than Party B's purchase. After all, the fact that it was the Prophet's deliberate direction to introduce Party C is sufficient evidence that Party C is indeed the focus of juristic intent. The Mathematical Appendix provides an analytical model to further substantiate the point that *ribā al-faḍl* may only emerge within a monopolistic environment.

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Mathematical Appendix

To provide analytical verification on how *ribā al-faḍl* is associable with monopolistic behaviour, we shall establish two main results as follows:

Result (1): if conditions of perfect competition cannot accommodate *ribā al-faḍl*, then *ribā al-faḍl* is analytically associable with an element of monopoly.

Result (2): under reasonable conditions about the preference structure of low quality/high quality goods, *ribā al-faḍl* cannot be accommodated by the model of perfect competition.

Accordingly, it follows that *ribā al-faḍl* transactions belong to the set of monopolistic transactions. Using set theoretic tools, we may define *ribā al-faḍl* transactions by X and monopolistic transactions by Y. Then the hypothesis we want to test is defined as:

$$X \subset Y \tag{1}$$

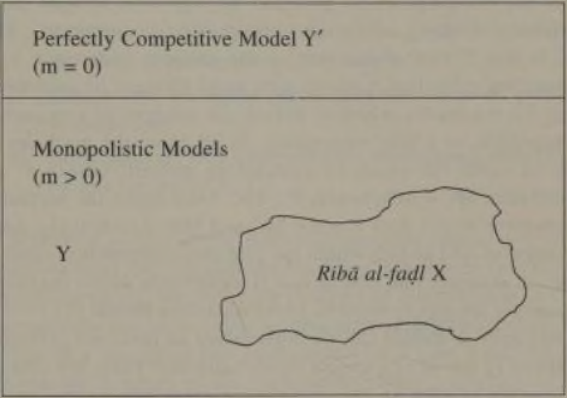
But this is too difficult to verify directly. Fortunately, we can resort to an equivalent expression that is easier to test, using the well known equivalence axiom:

$$X \subset Y \quad \Leftrightarrow \quad X' \supset Y' \tag{2}$$

It is the alternative expression: $Y' \subset X'$, where X' and Y' respectively stand for non-X and non-Y, that is monopoly free and *ribā al-faḍl* free transactions respectively. Then the equivalent expression simply states that the set of *ribā al-faḍl* free transactions (X') include the set of monopoly free transactions (Y'). This equivalent expression is easier to verify since Y' is analytically representable by the model of perfect competition.

Figure 1 below provides the set theoretic expression for the hypothesis, which we wish to verify analytically. Note that the larger set of *ribā al-faḍl* free transactions include perfectly competitive transactions as well as monopolistic transactions not of the *ribā al-faḍl* type. But what matters to us analytically is the result that if *ribā al-faḍl* belongs to the set of monopolistic transactions it cannot appear within the perfectly competitive model.

Figure 5.1: Our Hypothesis



The parameter m is defined below as reciprocal of the absolute value for the elasticity of demand. Producers under the perfectly competitive model face perfectly elastic demand curves for their products. Defining 'e' to be the absolute value of the demand curve elasticity, the degree of monopoly is measurable as:

$$m = \frac{1}{e}\begin{cases} > 0 & \text{for the range of all possible monopolistic models} \\ = 0 & \text{for the perfectly competitive model} \end{cases} \qquad (3)$$

This follows from the fact that e = ∞ for the latter, while it is finite for the range of all possible monopolistic models (sole monopoly, duopoly, oligopoly, monopolistic competition). The idea is that if *ribā al-faḍl* proves non-existent under m = 0, it follows logically that it exists with some element of monopoly (m > 0), no matter whether within the context of competing monopolists, or a sole monopolist. In all cases the producer is able to raise the price by restricting output, where at an equilibrium MC = MR, hence, P > MC. Only under the perfectly competitive model does P equal MC and MR. Accordingly, non-existence of *ribā al-faḍl* within the perfectly competitive model is a logical evidence that *ribā al-faḍl* is identifiable within the range of possible monopoly models. This establishes **Result (1).**

To establish **Result (2)**, we must define an idealised perfectly competitive model of a simple barter economy. Then, the crux of the matter relates to the preference structure of the usual heterogeneous goods (for example, dates, wheat, etc.) as opposed to the preference structure of homogeneous goods, differing only in quality. For analytical simplicity, we assume that there are only two well defined quality levels, good quality and bad quality, for the set of homogeneous goods that are subject to the *ribā al-faḍl* ruling.

Perfectly Competitive Barter Model

We assume a very large number of producers, each facing a set of perfectly elastic demand curves for their product, at the market determined barter exchange rates for their product as against every other product. Thus, all producers meet at the market place to exchange their products through barter. For such a model no participant can get into an exchange under the incentive to re sell the acquired goods at profit, so long as he is unable to influence market rates. More specifically, the main conditions of the perfectly competitive barter model are:

i. Barter exchange rates $\{P_{X,Y}\}$ for any two goods X, Y, are fixed and given as market determined values.

ii. Participants are utility maximisers for the given period's consumption.

iii. Participants are fully informed about the exchange rates $\{P_{X,Y}\}$ for any two goods X, Y.

Within the context of this frictionless perfectly competitive barter model we must also maintain the condition that there is *zero search cost*. Accordingly, the matching in terms of consumption taste is automatically and immediately secured between any two exchanging parties. In a simplified two goods model (X,Y), such matching is expressible in terms of the participants' MRS_{xy} values (i.e. the absolute value for the marginal rate of substitution), for the two goods.

Hence, given any two parties A and B with MRS^{A}_{XY} and MRS^{B}_{XY} respectively, and a given market determined exchange rate, P_{XY}, the following two conditions are necessary and sufficient for exchange between the two parties, namely:

$$\text{(i)} \quad MRS^{A}_{XY} > P_{XY} > MRS^{B}_{XY}$$

or

$$\text{(ii)} \quad MRS^{A}_{XY} < P_{XY} < MRS^{B}_{XY} \qquad (4)$$

Then, at equilibrium, the following condition is satisfied:

$$\text{(iii)} \quad MRS^{A}_{XY} = P_{XY} = MRS^{B}_{XY} \qquad (5)$$

The idea is that the convexity of the XY indifference curves is crucial for the shift from condition (4) to condition (5). If convexity property fails to be satisfied, as is the case between different quality homogeneous goods (for example, low quality dates and high quality dates), satisfaction of the above conditions becomes questionable under the perfectly competitive model. Alternatively, conditions (4) and (5) can easily be satisfied for homogeneous goods when we introduce an element of monopoly.

Ribā al-faḍl within the Competitive Model

The idea is that under normal conditions for any two *homogeneous* goods defined as high quality (X) and low quality (X′), the indifference curve is linear. Hence, the rate of marginal substitution MRS becomes a fixed number, i.e.

$$MRS_{XX'} = \alpha \qquad \text{for all possible X, X}' \text{ combinations.} \qquad (6)$$

The linearity of indifference curve implies that at any given level of satisfaction the individual has a *strict preference of high quality to low quality* which is insensitive to how much low quality he is offered in place of the high quality. This idea is reflected in the fixity of MRS, which is defined as:

$$MRS_{XX} = \frac{MU(X')}{MU(X)} = \alpha \qquad (7)$$

where $MU(X')$ is the marginal utility of the lower quality good and $MU(X)$ is the marginal utility of the high quality good. On the other hand, this implies that: $0 < \alpha < 1$. For example, $\alpha = 1/2$ implies that two units of the low quality are equal, in utility, to one unit of high quality.

Hence, to show how any two parties A and B can engage in *ribā al-faḍl* within the perfectly competitive environment, we must compare their preference parameters α_A, α_B with reference to conditions (4) and (5) above. Yet, it is more illuminating to examine the overall structure of preference parameters $\{\alpha_i\}$ for all possible participants ($i = 1, 2, \ldots n$) in the market. We shall define the *market's preference rate*, α_o, for the given good (for example, dates) as the mathematical average (expectation) of all individual preference rates in the economy:

$$\alpha_o = E(\alpha_i)\ ; \quad \forall i \qquad (8)$$

Note that the market's preference rate, α_o, must be identical to the fixed market exchange rate for the two homogeneous goods X, X′ differing only in quality, i.e. $\alpha_o \equiv P_{XX'}$. We shall now look at the structure of the different α_i with special reference to the effect of wealth.

Effect of Wealth

It can be seen from (7) that α_i is closer to zero for wealthier participants, but closer to unity for poorer participants. In the limit $MU(X') = 0$ for a very wealthy person who never considers low quality, implying that $\alpha_i = 0$ is the limit for the wealthy class.

Alternatively, $MU(X') = MU(X) \Rightarrow \alpha_i = 1$ for the very poor class who only care for quantity regardless of quality. Hence, given that α_0 is the average (market) preference parameter, we may stipulate that:

(i) $\alpha_i > \alpha_0$ for poor people

(ii) $\alpha_i < \alpha_0$ for wealthier people

Conditions for *Ribā al-faḍl*

Now, if we refer to the classic case of Party A (the owner of high quality dates) and Party B (the owner of low quality dates), then it is easy to establish the necessary and sufficient condition for *ribā al-faḍl* between these two parties under the perfectly competitive model, namely:

$$MRS^A_{XX'} > P_{XX'} > MRS^B_{X'X}$$

This can alternatively be written as

$$\alpha_A > \alpha_0 > \alpha_B \tag{9}$$

To achieve a state of equilibrium under the perfectly competitive model in comparison with (5), we must be able to move from (9) to (10) below:

$$\alpha_A = \alpha_0 = \alpha_B \tag{10}$$

Hence, the critical question is whether or not conditions (9) and (10) can be satisfied under the perfectly competitive model for *ribā al-faḍl* goods as they do for usual goods.

Ribā al-faḍl and the Preference Structures

There are three possible structures for the preference parameters $\{\alpha_i\}$ in the economy:

i. **The Uniform Structure:** This is represented by the simple model:

$$\alpha_i = \alpha_0 \, ; \quad \forall i$$

That is, every individual participant adopts the *market preference parameter* α. But under this structure it follows that:

$$\alpha_A = \alpha_0 = \alpha_B$$

and, hence, *ribā al-faḍl* cannot arise since condition (9) is not met, while the equilibrium condition (10) is automatically met. Hence, it is a state of equilibrium where *ribā al-faḍl* should never take place.

ii. **The Non-Uniform Structure:** Under the non-uniform structure there are two possible cases, namely:

(a) $\quad \alpha_A < \alpha_0 < \alpha_B$

where *ribā al-faḍl* cannot arise since condition (9) is not met. The other is:

(b) $\quad \alpha_B < \alpha_0 < \alpha_A$

Here *ribā al-faḍl* can arise, since condition (9) is met, but the equilibrium condition (10) cannot be met due to the fixity of α_A and α_B at all levels of X, X′. The result is a corner solution, implying *exchange of all for all*.

The above analysis shows that *ribā al-faḍl* under the perfectly competitive model fails to satisfy the normal conditions of exchange that are satisfied by usual goods. The only possible case is a corner solution that cannot be accepted either theoretically or practically. On the one hand, a corner solution deviates from the normal properties of a perfectly competitive model, where convexity properties are necessary for the attainment of the model's optimality conditions. On the other hand, such a corner solution cannot describe the practical exchange of *ribā al-faḍl*.

Even more critically, the condition which results in such a corner solution may not even arise. If we refer to the Section on Wealth Effect, this condition means that Party A belongs to the poorer class ($\alpha_i > \alpha_o$) while Party B belongs to the wealthier class ($\alpha_i < \alpha_o$). This is too abnormal, given that Party B is the owner of low quality dates, while Party A is the owner of high quality dates.

Hence, for both practical and theoretical reasons we shall disregard such an abnormality. It follows that *ribā al-faḍl* cannot exist under the perfectly competitive model like other usual exchanges of non-homogeneous goods. Hence, **Result (2)** is established.

If *ribā al-faḍl* fails to obtain within the perfectly competitive model, it means that Party B must follow the Prophet's direction in order to satisfy his want for high quality dates. That is, sell X at price (another good) and then use this money to buy Y.

The Rise of Monopolistic Behaviour

It is easy to show how convexity property required by conditions (4) and (5) can be satisfied for *ribā al-faḍl* once we deviate from the perfectly competitive model and introduce a monopoly element. In this case the two goods X, X′ are no longer perfect substitutes in consumption for Party A. The holding of low quality good X′ is intended for trade purposes rather than consumption purposes. When the trade motive in introduced, we must allow for the possibility that

Party A has a monopolistic power (i.e. $m > 0$), such that he can influence the market price of X' (in terms of other goods) by controlling its supply. In this case the low quality good X' becomes a unique *investment asset* for Party A as opposed to X, thus allowing for the convexity of indifference curve when combined with high quality good X. The possible monopolistic model for *ribā al-faḍl* still needs more elaborate analysis, which is however beyond the scope of our present study.

To sum up we may draw attention to the following two points:

1. Qualitative differences for *ribā al-faḍl* goods may not all be of the strict preference type, (i.e. high quality preferred to low quality). For example, certain different qualities of dates cannot be graded on a strict preference scale, implying that the linearity of difference curve may no longer hold. Yet, it is easy to show in this case that the *market's preference parameter*, α_o, converges on average to unity, implying that participants would exchange *equal* quantities without *ribā al-faḍl*.

2. Our findings with reference to the perfectly competitive model are based on the assumption of *utility maximisation* for participants, which may hold in practice but not as strictly as assumed in theory. This may account for the possible rise in *ribā al-faḍl* even for a fairly competitive market without a monopolistic intent. What we have essentially established is a strong economic tendency of association between *ribā al-faḍl* and monopolistic behaviour.

COMMENTS

*Mabid Ali al-Jarhi**

This paper carries an interesting and possibly seminal idea. Surprisingly, the author chooses to leave it aside and goes after another one of little merit.

The paper starts with dividing an economy into two main sectors, the market and *irfāq* sectors. It continues to outline some of the special characteristics of the latter sector in an Islamic economic system as well as the factors that would make it more prominent in providing both prevention and cure for poverty. Through reading the first part **, I expected the following:

1. The author would carry out his vision to show us the relationship between the two sectors and how they would interact. This would be done through the study of the effects of poverty reduction on human capital and how this could ultimately affect production and prices. The potential of making the aggregate level of output as a function of wealth disparity

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** While revising the paper, the author has deleted a major portion of the part under reference [Editor].

among individuals has been hinted at in the literature, but received little formal treatment.

2. The author could set two simple models for an Islamic and a conventional economic system, each containing a market and an *irfāq* sector. We would then find many aspects to compare between the two models.

Unfortunately, the author directed his interest to two arguments, neither of which appears to be worthy of his talent.

1. The issue of the treatment of interest rate elimination in an Islamic economy, and whether it should be considered on efficiency grounds or on re-distributional grounds

This particular point reflects a misunderstanding of the analysis presented by some economists on the subject. While *ribā* elimination could have redistributive effects, its main *raison d'être* is allocative efficiency.

2. The relationship of *ribā al-faḍl* with monopoly

The author has expended much energy on this point, making it the main focus of his paper. Yet it does not seem to be credible for the following reasons.

i. The reasons for the prohibition of *ribā al-faḍl* mentioned by *fuqahā'* are two. The first is the monetary aspect, called by the author a 'pricing property'. Commodities used as money serve the usual monetary functions. Their units must be designed to be exactly equivalent. Differences in weight or metal content would cause traders to incur higher transaction costs. This would reduce the 'moniness' of the commodity money, making it less suitable for use as a means of exchange as well as a unit of account.

ii. As to the proof of association between *ribā al-faḍl* and monopolistic behaviour, with which I find myself rather amused, my advice to the author is that his energy and talent should go somewhere else. It is sufficient to point out the following:

   a. The author attempts to distinguish between monopolistic and competitive transactions, as a prelude to placing *ribā al-faḍl* transactions into the latter category. This cannot work. Transactions are purchases and sales, or acts of exchanging goods and services. It would take considerable imagination to classify transactions into monopolistic and competitive in a manner that would make them *mutually exclusive*.

   b. The indifference curve between a low and high quality commodity as a straight line is erroneous. They are two distinct commodities, subject to diminishing marginal utility at different rates. The concavity of their indifference curve is a must.

   c. The two points above are sufficient to render the proof unworkable.

An aspect of the paper of less importance that I wish to comment on is the language, which appears in some cases to be too declarative. In particular, the description of conventional economic systems (capitalist, socialist and mixed) as 'secularist' is unjustifiable. I would prefer to describe them only as conventional. The Islamic economic system as developed by Islamic scholars is neither holy nor divine. It reflects our human understanding of the Scriptures, which is as human as we are.

COMMENTS

*Abdel Rahman Yousri**

The main objective of the paper is to demonstrate how *ribā* (usury) elimination helps in poverty alleviation. *Ribā* or usury is classified in Islamic jurisprudence into 'loan *ribā*' and 'sale or trade *ribā*' (*ribā al-faḍl*). The first kind is recognised by the majority of jurists and Islamic economists as equal to 'interest'. The second kind, i.e. trade-usury currently receives little attention from scholars because it is thought to be relevant only to barter exchange economies.

The impact of the removal of loan-*ribā* on income distribution has been shown through its curative function. On the other hand, trade-usury's removal is thought to affect income distribution through its preventive function. The author does not deny that the effect of loan *ribā* on income distribution has been dealt with in contemporary literature on Islamic economics. Yet he thinks that the ethical side of the loan *ribā* argument, i.e. the *irfāq* (benevolence) was not given sufficient care.

In secular economic systems, the author claims, a distributional strategy that is targeted towards poverty alleviation is necessarily

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dependent on the existence of a non-utilitarian sector or power, which is the government. In an Islamic economic system, in contrast, such a non-utilitarian power is endogenous as every Muslim is committed ideologically to a philanthropic or a non-utilitarian behaviour, in particular towards the poor and needy. Thus, the corrective or curative measures targeted at a fair or just distribution of income in an Islamic economic system are not dependent mainly or exclusively on an exogenous power, i.e. the government. The author emphasises the uniqueness of the Islamic economic system and its advantages over secular economic systems in this respect.

Turning to trade-usury's removal, the author focuses on its preventive function. Trade-usury practices in food items lead to monopolistic positions in their markets. Thus, prohibition of trade-usury plays an important preventive role against monopolistic practices and consequently helps consumers. This result is particularly important to poor consumers who assign a large portion of their budget to food. I would like to make the following comments:

1. The author has made a rather hasty statement that *ribā* elimination in Islamic financial schemes has not produced any tangible re-distributional effect in favour of the least fortunate and poverty stricken masses. In this context, he notices that 90 percent of the population in countries that took large steps against the interest system, two decades ago, are still living below the poverty line. In his opinion this is 'too ironical'. What is ironical in my opinion is to think that Islamic financial schemes established in some Islamic countries such as Islamic banks, have really succeeded in eliminating *ribā* from their transactions after two decades of experience. These schemes have introduced new financing techniques that are interest free from a purely juridical point of view. Yet, in practice some of these techniques could not be carried out correctly or fully as desirable. Blame cannot be placed only on the new Islamic financial schemes for deviation or shortcomings in application but also on

many exogenous factors. Let us only think of financial relations with a non-Islamic world as well as with many Islamic countries that until now do not have any interest-free banks. How can these relations be established on a truly interest free basis?

Minor dependence on true interest free methods such as *muḍārabah* and over-dependence on *murābaḥah* finance, for which Islamic banks have been severely criticised, prove that we are still midway after two decades. This is true whether we consider Pakistan, Iran and Sudan where Islamisation has taken place officially at the macro level or Egypt, Jordan and Kuwait, etc., where Islamic banking is practised in a dualistic banking system and dualistic economic and social conditions. Thus, it is unacceptable to assert that *ribā* elimination has not produced any tangible effect on income distribution.

On the other hand, the author should notice that many other factors, recognisable in secular and Islamic economics as well, affect income and wealth distribution in any society. We cannot just exaggerate the role of one factor such as *ribā* elimination. It should also be noticed that the figure quoted by the author, i.e. 90 percent living below the poverty line does not prove anything concerning the distribution issue. For even if 'absolute equality' is achieved in distributing income in countries that officially have fully Islamised their economic system, such as Pakistan or Sudan a 100 percent and not only 90 percent could still be living under the poverty line.

2. The example given under the Section '*ribā* paradox and the obvious resolution' is rather artificial and cannot be taken seriously. In a modern and advanced secular economy, a poor worker's family will be covered by health insurance services otherwise he will get lost as he will neither be able to borrow money from banks with interest nor buy medicine on credit terms from a pharmacy. However, if a pharmacy accepts to deal with such a poor man, the rate of interest charged for deferred sale purposes will be consistent with the current

rate charged by the banks. Insurance companies, it will be noticed, are covering most of the risks involved in this case. Now if a developing economy is considered, the poor worker's family may not be covered by any health insurance. Again a bank would not lend to this poor worker under any circumstances. This case is ruled out completely. A moneylender in the informal sector may lend to the poor worker. Available studies show that these moneylenders are real loan sharks. The interest rates which they charge small borrowers may rise to fantastic levels such as 500 percent 1000 percent or more per annum. On the other hand a purely utilitarian (a profit maximiser) pharmacy will never sell on credit terms in our developing economies to a poor worker.

The point which the author wishes to make with his 'dramatised example' is that a moneylender who gives a loan to the poor worker whilst charging an exorbitant rate of interest will be more 'humane' than the seller of medicine who turned the worker down. Now, in logic, if A and B are 'absolutely' lacking a certain attribute we cannot say that A is 'relatively' better in this attribute than B or vice versa. Going into details to prove that the behaviour of a loan shark can never be considered humane will take us to stories rather than economic analysis. A reference may only be made here to Shakespeare's *Merchant of Venice*. Leaving aside unrealistic examples, there is a probability that 'mercy' may come into the heart of a merchant of goods and motivate him to be 'beneficent' in some cases. For a moneylender such probability can never be assumed unless this person decides to abandon his business forever. Thus, in reality a poor worker who is in distress may still find a benevolent merchant who accepts to sell him his necessities of medicine or food. A merchant will never be as potentially merciless as a person who lives on usury unless this merchant himself is explicitly or implicitly involved in lending money with usury. Therefore, you will find in the Qur'ān that *"Allah has permitted*

trading and forbidden ribā." [2:275] Deferred sale was permitted among other kinds of sale and Muslim jurists explained that the conditions of deferred sale should not involve any implicit *ribā* transaction. If deferred sale was as exploitive as *ribā*, or may lead to more exploitation of the poor than *ribā*, it would have never been permitted by Allah. "*Allah commands justice, the doing of good, and liberty to kith and kin, and He forbids all shameful deeds, and injustice and rebellion: He instructs you, that ye may receive admonition*" [16:90].

Evaluation of the methodology, analysis and the results

1. The author has explored the necessity of a non-utilitarian or philanthropic sector (or behaviour) for a just income distribution on the one hand and for effective removal of *ribā* on the other. It should be noted that a loan in Islamic Sharī'ah should only be given on a philanthropic basis. A loan, therefore, can never be but a benevolent loan. However, in practice the case of a loan that is based on *irfāq* or philanthropy will only arise when we take the special case of a loan given to the poor or the needy for his consumption. For people who need finance for their business, particularly well-off businessmen, talking of benevolent loans is rather misleading, with minor exceptions. Business finance should be done only through profit or loss sharing for the sake of the rational use of scarce capital resources. Only and exceptionally benevolent loans based on the *irfāq* principle (philanthropy) may be given to small entrepreneurs who are willing and technically capable of operating some kind of small size labour intensive business but they lack the small finance which would enable them to start. Even in such cases the utmost care should be taken lest scarce capital resources are wasted on projects that are not advantageous for society or are misused by some bad entrepreneurs. The Islamic Sharī'ah imposes

upon all Muslims the responsibility of rational use of available resources, which are bounties of Allah.

In fact, the author's over-emphasis on *irfāq* as a factor that should necessarily accompany the prohibition of *ribā* has put limits on the analysis. We do not find in the paper an analysis of the effects of interest-free finance given to business on poverty alleviation. We have seen how interest-free loans based on *irfāq* would effectively help in poverty alleviation. But the paper has totally neglected the possible effect on poverty of the interest-free finance given to business on the basis of profit or loss sharing. This is a rather serious shortcoming. A few remarks on this issue may be in order.

First, interest-based finance plays a serious role in wealth concentration and income distribution. Literature has shown that bank lending on the basis of creditworthiness is positively helping the rich to be richer while depriving small businessmen of finance, which they need. Small businesses, which are mostly dependent on labour intensive techniques, represent important earning sources for a considerable number of low-income labour. They also produce goods and services that are relatively important to low-income groups. These facts are particularly true in developing Muslim nations and they require further investigation through economic research.

Second, the relative importance of interest as an item in total costs of production should be investigated in general. Yet this investigation should be carried out particularly in food production as well as in other kinds of production, which are important for low-income groups.

Third, how far does interest-based finance create a tendency towards a structural change in output that is favourable to high-income groups? In other words, would the profit maximising firms financed with interest on a creditworthiness basis produce more of the goods and services that satisfy high-income groups? It has been

noticed in Egypt that the construction industry has over invested in building hotels and luxurious houses for high-income groups while almost totally neglecting the housing needs of the low-income group. The expansion of the Egyptian construction industry has been financed by commercial banks on an interest basis

2. With respect to trade-usury, the author has shown a deep interest in finding out the Sharīʿah intent of its prohibition. In Islamic jurisprudence several interpretations were given by different scholars to trade-usury and the wisdom of its prohibition. These interpretations are all based upon the Prophet's (peace be upon him) *ḥadīth* concerning usury. The most famous and comprehensive trade-usury *ḥadīth* is the one investigated and recorded by Bukhārī and Muslim and agreed upon by both of them as truly reliable and correct. The meaning of the *ḥadīth* as expressed by the Prophet (peace be upon him) is: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt, same for same in exactly equal exchange, hand to hand, whoever gives more or asks for more is involved in *ribā*, the taker and the giver are alike (in sin)."

There are other *aḥādīth* reported by Bukhārī and Muslim on trade-usury as truly reliable and correct. The author depends upon one of these heavily. The *ḥadīth* says that one of the Companions of the Prophet (peace be upon him) brought him high quality dates from the town of Khaybar. The Prophet (peace be upon him) asked, Are all the dates of Khaybar like this? The Companion said, I swear not, O Messenger of Allah but we get one *ṣāʿ* (about one kilogram) of these high quality dates in exchange for two *ṣāʿ* of the low quality dates. Then the Messenger of Allah (peace be upon him) said, Don't do this but exchange same for same in equal quantity or sell your low quality dates and with its price you can buy high quality dates.

The wisdom of prohibition of trade-usury was not clear to everyone even to some of the close Companions who lived with the

Prophet (peace be upon him) in Madinah. The explanation given later on for the wisdom or the intent of trade-usury prohibition went in different directions. Yet all explanations given seem to be quite plausible and complementary. To sum up: first, people are prevented from exchanging one commodity for the same in different amounts (by scale or by measure) to avoid injustice in this particular barter exchange. Injustice is bound to happen in this exchange because of lack of experience and information on quality. Some people would gain much more than others because they are more experienced or better informed on the quality of the exchanged goods. Pure luck will also play a role in distributing gains from barter exchange of the same commodities. Thus, people were advised by the Prophet (peace be upon him) to use a medium of exchange if they want to trade wheat for wheat or gold for gold. A medium of exchange in this particular exchange would help the exchangers to be clearer and well informed of the market price of what they sell or what they buy instead of depending on their own valuation. It should be noticed that if people are not using a medium of exchange they have to exchange an amount of commodities such as wheat or dates etc., for the same amount of the same commodity hand-to-hand whatever differences in quality there are. Then there will be no motive for exchange for anyone who possesses a higher quality commodity. Upon this explanation some contemporary scholars believe that the prohibition of trade-usury helped significantly in transferring the Muslim nations' economies after the era of the Prophet (peace be upon him) from dependence on barter exchange to dependence on money exchange which enhanced their economic growth.

Second, gold and silver, two of the six commodities mentioned in the *ḥadīth* of trade *ribā* prohibition, were money in the Prophet's (peace be upon him) era and for many centuries after him. Trade in money is serious since it is bound to lead to well-known *ribā*

transactions. Thus, in the *ḥadīth* two kinds of restrictions were imposed on the trade of money to prevent *ribā*. First, a kind of metallic money should not be exchanged for the same except in equal exchange even if the quality is different. Thus, there is no motive to exchange the same kind of money. A door for *ribā* in money was closed. Later on Muslim jurists established a rule based on this; namely that a certain currency should not be exchanged for the same in different amount. Second, if a kind of money is traded for the same and in equal exchange or for another kind (for example, gold for silver) in different quantities, as commanded by the Prophet (peace be upon him), money should be delivered instantly, 'hand-to-hand'. This second restriction is imposed on money exchangers to prevent a delay in payment which may, at a future date, lead to demands for extra money above what is agreed upon. In this way another door for *ribā* connected with money was closed. It should be noticed that these special interpretations of usury were unknown to scholars in the medieval period but were not totally absent from Jewish literature.

Third, four of the six commodities mentioned in the *ḥadīth* concerning trade *ribā* prohibition are food items; namely wheat, barley, dates and salt. But these items are homogeneous, storable, easily divisible in very small units and measurable. People frequently used them in the medieval period as mediums of exchange within the barter system. Thus, they played the role of money, similar to gold and silver. Accordingly, they were liable to be demanded for their own sake and kept as assets as long as they could be stored in good condition. Accordingly, an exchange of any one of these commodities for the same would not really be different than exchange of gold for gold or silver for silver. Under these conditions bartering wheat for wheat or barley for barley, etc. opens doors for *ribā* just like bartering gold for gold or silver for silver. Later on some jurists, on the basis of deduction, treated

homogeneous commodities which have the same properties as those mentioned in the *ḥadīth* in the same way.

Fourth, bartering any of the four food items for the same should not be done on an utilitarian basis unless the quantities exchanged are not equal, which cannot happen except if qualities are also different. Imām al-Ghazālī tried to explain this kind of barter by searching into its reasons.

Each exchanger must be looking for a sort of 'gain' for himself and each one also must have a 'surplus' above his own basic needs of the particular food item which is subject to the exchange. A gain may be in the form of additional satisfaction if he is a consumer or additional stock of the commodity (similar to money) if he is a merchant. The consumer in this case must be looking for a better quality of the same kind of food than what he already possesses. This is a sort of luxury. The merchant on the other hand who is accumulating more of the same kind of food may become a monopolist in the market. If this happens it would be against the public interest and particularly unfavourable to poor consumers. Imām al-Ghazālī considered that both parties are wrong because they establish a kind of trade in food that may lead potentially to monopolies in the food market. Imām al-Ghazālī who belonged to the Shāfiʿī school of *fiqh* ruled as illegal any barter in similar food items and not only in the four commodities mentioned in the *ḥadīth*.

Against this background it is quite surprising to find that the author of this article has concentrated on the monopolistic aspect of trade-usury to the extent that he neglects all other aspects. Does the author think that these other aspects are 'unimportant' or 'neutral' to the question of poverty alleviation? Is there not a direct gain accruing to all people from a 'just exchange', a matter which would be realised when they are better informed about the market value of whatever commodity they have in terms of another commodity? Would this 'just exchange' not be of particular

importance to the poor section in society, especially when they exchange food necessities? Would not the prevention of trade-usury close the back door to loan-usury? Thus, affecting the costs of production and prices in general is a matter that is reflected in the cost of living in society. Would not trade in food items that functioned as money affect their prices, irrespective of the monopolistic consequences and, therefore, affect the cost of living? Would not trade in the four food items in the manner prohibited by the Prophet (peace be upon him) affect their market prices irrespective of the monopolistic consequences? Should we think that as long as these items functioned as money, or quasi money, their accumulation, even by many merchants is bound to reduce their supply, raise their value and affect the general standard of living? Would not the poor suffer more than others in this case? These questions deserve discussion and call for further investigation.

Finally, I think that an attempt to draw a relationship between the removal of monopoly in the food market, upon the prohibition of trade-usury, and poverty alleviation while theoretically useful is practically of minor importance. Barter exchange has almost disappeared from all the world markets with the exception of village markets in some developing countries.

If the author wishes to say that the removal of monopolistic practices in food trade would help effectively in alleviating poverty in society we would certainly agree with him. Yet we have to remind ourselves that in all modern economies, monopsonies or monopolies will arise in food markets because of other reasons than trade-usury. Thus, talking about trade-usury prohibition as an effective measure against monopolistic practices is rather out of date, with minor exceptions, as I have mentioned above.

Even at the time of the Prophet (peace be upon him) available evidences reveal that monopolistic practices were removed by different means and policy measures. The Prophet (peace be upon

him) waged a severe attack against monopolists through direct supervision of the market transactions to ensure its freely competitive character. Tolls imposed on entry as practised by Jewish merchants in Madina markets before Islam were abolished entirely. The principle of free entry was strengthened by making the market area available to everyone on an equal footing at any time. Reserving areas in the market on a permanent basis was not allowed. Merchants were encouraged through moral persuasion to increase their supply particularly in the food market. Certain practices that establish special markets away from the general market area were forbidden, as these potentially raise prices. Giving true information on qualities of the commodities traded in the market was emphasised as being closely related to belief. Considering all these measures that were taken against monopoly, the question is how important the role of the prohibition of trade-usury is in eliminating monopoly and then in alleviating poverty?

CHAPTER 6

The Problem of Risk and Insurable Interest in *Takāful*: A Jurisprudential Analysis

*Mohammad Daud Bakar**

1. INTRODUCTION

This paper aims to examine the position of both risk and insurable interest in the context of Islamic insurance theory and practice. It has been observed that since the introduction of the first Islamic insurance (hereafter, referred to as *takāful*) product in 1979 in Sudan, the issues of risk and insurable interest have not been subjected to any serious and thorough study either by Muslim economists or by Muslim jurists.[1] It is of relevance to devote this paper to discussing and analysing the issues of both risk and insurable interest, since

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[1] The discussion in this paper is biased towards legal and Sharī'ah perspectives as the writer's expertise lies in the legal profession and not in economics.

insurable interest, which is closely related to insurable risk, is one of the fundamental legal principles under conventional insurance law.

Furthermore, it is not an exaggeration to note that insurable interest has been perceived as the most important legal principle compared to other legal principles, namely principles of indemnity, subrogation and utmost good faith. This is simply because, as will be explained later, the principle of insurable interest is the element that distinguishes insurance from gambling and wagering.

It is also worth pondering on some related issues; *inter alia*, how does *takāful* perceive the principle of insurable risk and insurable interest? What is the acceptable methodology from an Islamic viewpoint through which one can ascertain the intended meaning of insurable risk and insurable interest? What would be the impact if *takāful* were to perceive the principles of insurable risk and insurable interest different from the conventional perspective? Should *takāful* practice deviate from conventional practice on issues of insurable risk and insurable interest even if the deviation is economically non-viable and non-feasible?

The paper seeks to reconsider the meaning and interpretation of both insurable risk and insurable interest for the consumption of the *takāful* industry since the existing interpretation may not be compatible with Sharīʿah principles. The major basis for this contention is that *takāful*, unlike conventional insurance, does not have a relationship of insurer-insured. All of the participants, i.e. policyholders, are both the insurers and insured. The *takāful* company or operator, irrespective of whether it operates under commercial *takāful* or cooperative *takāful*, does not assume the responsibility of insurer. Does this major distinction between the two insurance systems and philosophies provide a valid ground to reconsider the existing principles of conventional insurance including insurable risk and insurable interest? The paper seems to support this line of thinking.

2. ISLAMIC INSURANCE OR *TAKĀFUL*: A BRIEF INTRODUCTION

Confusion may arise due to some misconception about the Islamic insurance operation in contemporary practice. Therefore, without having a clear understanding of the theory and practice of *takāful*, discussion on issues such as risk and insurable interest would be misleading. It is illogical and ironic for *takāful* to operate under the same purview and preamble as conventional insurance. It follows from this that it is unjustifiable that the perception of the issues of insurance be the same under the two schemes, namely conventional insurance and *takāful*.

Takāful, is an Arabic word that signifies mutual guarantee wherein parties in *takāful* provide guarantee and help to one another. *Takāful* is based on the Qur'ānic concept of *ta'āwun* (mutual assistance) as Allah enjoins upon Muslims: "*Help you one another unto righteousness and pious duty. Help not one another unto sin and transgression, but keep your duty to Allah*" [5:2]. Section 2 of the *Takāful* Act of Malaysia defines *takāful* as "a scheme based on brotherhood, solidarity and mutual assistance which provides for mutual financial aid and assistance to the participants in case of need whereby the participants mutually agree to contribute for that purpose".

Takāful differs from conventional insurance in the sense that the company is not the 'insurer'. The persons participating in the scheme mutually insure one another and this is the very essence of the word *takāful*. The *takāful* operator simply handles the matters of investment, business and administration of insurance practices. In terms of operation, *takāful* may operate on either a commercial or cooperative basis. The Sudanese *takāful* operation, for example, is based on cooperative or mutual *takāful* in the sense that the *takāful* company 'consists' of the participants. The participants themselves elect the Board of Management to manage the insurance activities and to invest the fund. All the profit or surplus, if any, is put into the

fund to be distributed to the participants proportionately. The members of the Board are paid for their professional services. In Malaysia, it is based on commercial *takāful*, that is the *takāful* fund is managed and invested by a commercial and corporate body that does not belong to the participants. The whole purpose of the business is to earn an underwriting surplus plus other revenues from investment activities whereby this surplus is shared between the company and the participants.[2]

This explanation shows that participants, the insured and insurers, could agree on many terms in relation to 'insurance' on the basis of mutual contribution and mutual indemnity on which policyholders under conventional insurance could not. While the focus of the former is more on mutuality, the emphasis of the latter is on financial feasibility as the insurance company would be the ultimate party in providing indemnity. It is on this basis that the paper seeks to explore how the distinct concept of both insurance schemes would affect the operations of insurance with regard to certain principles such as insurable risk and insurable interest.

3. RISK AND ITS CLASSIFICATIONS

There is no single definition of risk. The word 'risk' has been variously defined as chance of loss, the possibility of loss, uncertainty, the dispersion of actual from expected results or the probability of any outcome different from the one expected [Vaughan and Vaughan (1996)]. While some books have preferred the definition of risk as a condition in which there is a possibility of an adverse deviation from

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[2] The issue of sharing the surplus is one of the contentious issues under commercial *takāful*. The writer is of the view that sharing of the surplus under the *muḍārabah* principle is not permissible. Perhaps, the basis of the contract of commercial *takāful* must be changed into a *ju'ālah* or *wakālah* contract. Only then, would the company (the shareholders) be able to share in the surplus as either commission or fee.

a desired outcome that is expected or hoped for,[3] other authors have defined it as uncertainty concerning the occurrence of a loss.[4] Though it appears to be simple, this word may invite many uncertainties amongst the practitioners. As it stands, one cannot appreciate the difference between risk and other risk-related terms such as uncertainty, peril, hazard, loss, etc. Also, one wonders whether these terms do matter in insurance because one insurance policy may cover one of these 'terms' whereas the other insurance policy may cover the other. To be certain of the meaning of risk, particularly with regard to insurable interest, an attempt will be made to differentiate between these legal terms. We will reproduce briefly what has been said on these terms in some of the insurance books. After that, we will critically analyse the very meaning and concept of risk that is intended in the insurance dictionary.

To begin with, we look at the word 'hazards'. Hazards are acts or conditions that increase the likelihood or severity of a loss. Hazard may be a physical hazard or a moral hazard.[5] Either one of these may contribute to the actions of hazards that may result in perils. Perils are used to refer to the cause of the risk and this includes fires, automobile accidents, thefts, earthquakes, windstorms, illness and hundreds of other causes of uncertainty.[6] Therefore, even though a peril is a cause of uncertain loss, the hazard may increase this uncertainty. For example, fire is the cause for the loss due to fire but defective wiring is, for example, a physical hazard that increases the chance of a fire.[7]

The peril, with or without the hazard, would create a risk in a given situation. If a car is totally destroyed in a collision, the collision is then the peril, or cause of risk of accident. Obviously, when the

[3] Vaughan and Vaughan (1996), p. 5.
[4] Redja, G.E. (1989), p. 3.
[5] Bickelhaupt, David (1983), p. 8.
[6] Ibid., p. 7.
[7] Redja, op. cit., p. 5.

accident took place, which was uncertain before the event, what would result is the loss. The loss is the undesirable end result of risk against which the insurance would provide indemnity. The loss, generally speaking, is the decrease or disappearance of value that resulted in an unexpected or at least unpredictable manner.[8] From this brief analysis, we can conclude by saying that risk is the uncertain event caused by peril (that may be coupled by hazard), the result of which is the loss.

As risk is of different types and classifications, this section will shed some light on these classifications as attempted by Western economists and insurance theorists. They have classified risk into many groups according to many different perspectives. Risk, based on the nature of the loss, may be either financial risk or non-financial risk. While adversity in the former case involves financial loss, the adversity in the latter case involves non-financial loss.[9] Risk can also be classified as static or dynamic risk. Dynamic risks are those that result from changes in the economy such as changes in the price level, consumer tastes, income, output and technology advancement. This risk changes with the change in the economy. Static risks, on the other hand, involve losses that would occur even if there were no changes in the economy. These losses arise from causes other than changes in the economy, such as perils of nature and the dishonesty of other individuals. As static risks are generally predictable, static risks are more suited to treatment by insurance than dynamic risks.[10] Another classification of risk that is relevant to the discussion is pure risk and speculative risk. Pure risk is 'pure' in the sense that it does not mix profits and losses. The business of insurance is concerned with the economic problems created by pure risk. A more common example of pure risk is that found in the ownership of property. With regard to such a peril as a windstorm, the owner may either suffer a

[8] Bickelhaupt, op. cit., p. 9.
[9] Vaughan and Vaughan, op. cit., p. 8.
[10] Ibid., p. 8.

loss or not. There cannot be a gain. In contrast, speculative risk is defined as a situation where either profit or loss is possible. If one buys 100 shares of common stock, one would profit if the stock price rises but would lose if the price declines.[11]

For several reasons, under current practice only pure risks are insurable. Among other reasons, the law of large numbers can be applied more easily to pure risks than to speculative risks. Also, society at large may benefit from a speculative risk even if someone loses, but it is harmed if a pure risk is present and a loss occurs. For example, a firm may develop a new technological process for producing computers more cheaply. As a result, a competitor may be forced into bankruptcy. Despite the bankruptcy, society benefits since the computers are produced more efficiently at a lower cost to consumers.[12]

4. INSURABLE INTEREST

Insurable interest as defined by insurance dictionaries refers to the interest an individual must have in insurance coverage carried by someone else.[13] From a legal perspective, insurable interest means that the insured or policyholder must have a particular relationship with the subject matter of the insurance, whether that be a life or property or a liability to which he might be exposed. The absence of the required relationship renders the contract illegal, void or simply unenforceable (depending on the type of insurance).[14]

It seems from the discussion that the very purpose of stipulating this principle or test is to determine the motive for purchasing insurance, and in the assignment of a beneficiary in a life insurance policy. For example, a wage earner applies for life insurance, and names a spouse and children as beneficiaries. The insurance company

[11] Rejda, op. cit., p. 6.
[12] Ibid.
[13] Thomsett, Michael, *Insurance Dictionary*, p. 100.
[14] Birds, John (1993), p. 33.

recognises that, in the event of the unexpected death of the insured person, the family would suffer an economic loss. Accordingly, they have an insurable interest. On the contrary, one individual may offer to pay the premiums on a life insurance policy of another person, if that person names him as beneficiary. The insurance company, however, will not issue the policy on this basis, as it is a wager rather than a contract for insurance.[15]

One wonders whether the principle of insurable interest is of a requirement just to avoid gambling and wagering practices or is there any legal justification that is more appealing? The history of the requirement of this principle seems to suggest that the very purpose of this requirement is to avoid wagers and other criminal offences.[16] Therefore, the Life Assurance Act 1774, the first Act on insurance in the United Kingdom, prescribed that the indemnity is paid to the insured against a loss he actually suffers provided that he can show that he had an interest at the time of loss.[17] Furthermore, he can recover no more than the amount of the value of his interest.[18] Many modern statutes on insurance later adopted these provisions.[19]

However, modern statutes have also provided many exceptions to this requirement. The defunct Insurance Act of Malaysia (1963), for example, allowed a policyholder to insure his spouse, child or ward who were minors at the time the insurance was effected. This exception also included anyone on whom that person was at that time wholly or partly dependent.[20] Section 152 of the Insurance Act 1996 also gives the exception to the employer-employee relationship.

Before we embark on discussing the jurisprudential issues of the above position of law, it is relevant to see how *takāful* laws such as

[15] Thomsett, op. cit., pp. 100-101.

[16] See the preamble to the Life Assurance Act 1774.

[17] *Lynch v. Dalzell* (1729) 4 Bro. P.C. 431.

[18] Section 3, The Life Assurance Act 1774.

[19] Section 152, The Insurance Act 1996, Malaysia.

[20] Section 40, The Insurance Act 1963, Malaysia.

The *Takāful* Act 1984 in Malaysia (hereafter, referred to as *Takāful* Act) treated the principle of insurable interest. The *Takāful* Act does not require the element of insurable interest in Family *Takāful*. According to a scholar, the nature of Family *Takāful* makes this element irrelevant as a participant participates in this scheme only for the benefit of himself and his family. He cannot do so for the purpose of benefiting, or on behalf of, a third party. Therefore, the absence of the requirement of insurable interest does not and cannot result in wagers or give rise to the temptation to destroy lives [Mahmood, Nik Ramlah (1991)]. The *Takāful* Act is also silent as to the requirement of insurable interest in General *Takāful*. The Report of a Committee[21] however, recommended that such a requirement be introduced by the company as a condition for participation and that in the absence of such an interest a General *Takāful* contract ought to be regarded as void. The Report defines insurable interest as a financial interest in the subject matter of the General *Takāful* contract. The Report justifies this recommendation by stating that, whilst not transgressing the teachings of Islam, the requirement of insurable interest will in fact ensure that justice is done by requiring that adequate compensation be paid to the claimants.[22]

5. SHOULD THE *TAKĀFUL* BE CONFINED TO PURE RISK?

As has been previously explained, modern insurance companies have confined their coverage to pure risks. Speculative risks are not covered because providing coverage on risks that are speculative in nature would resemble gambling. Is this contention true from an

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[21] In 1982, the Government of Malaysia constituted a Committee on the setting up of an "Islamic Insurance Company in Malaysia". The Committee later recommended the adoption of *takāful* as an acceptable Islamic form of insurance and suggested broadly the mode of conducting this business. The Federal Government of Malaysia, accepting the recommendations, enacted the *Takāful* Act in 1984.

[22] Ibid.

Islamic legal theory perspective? Bearing in mind the very concept of *takāful* in Islam, which is based on brotherhood, solidarity and mutual assistance that provides for mutual financial aid and assistance to the participants, it could be said that *prima facie*, all types of risk are insurable from an Islamic point of view. As the *takāful* contract is meant to provide mutual help and assistance, then there should be no objection for the participants to agree amongst themselves, perhaps in one group under the classification theory, to mutually contribute to a pool of funds and to mutually indemnify one or more participants faced with the loss resulting from a risk, be it pure or speculative. There is no principle of Islamic law that would render this agreement that is based on the *tabarruʿāt* concept, null and void. Above all, the principle of law in all matters is of permissibility unless proven otherwise [al-Nadwi (1994)].

The explanation of the above *prima facie* conclusion is as follows. The first argument is that every action is vulnerable to speculative risk even though this action has been classified as of pure risk. In other words, it is very difficult for a person to undertake a venture that carries only pure risk, i.e. only fear of loss without any hope of gain [Siddiqi, M.N. (1985)]. For example, a person working in a factory with the attendant occupational hazards or a taxi driver who is driving his car with the danger of accidents will always hope for gain out of their work. Insurance coverage, as it is, will provide a kind of indemnity not only to cover the loss but also, impliedly, future gain. This is because if a taxi driver cannot drive the car as a result of the accident, his future gain is also in jeopardy. Thus, a person participates in a *takāful* scheme to protect not only the immediate loss but also, to some extent, the loss of future gain. This is different from gambling as in gambling there is no inherent risk before the commencement of the gambling transaction. The financial risk under gambling could have been avoided if the gambler wanted to do so. Whereas in ventures involving speculative risk such as investment activities, business enterprises and the like, there is an inherent risk,

though speculative, that the investor or the business man normally faces. Also, this risk cannot be avoided even if they wanted to do so simply because it is an integral element of those activities. Thus, to put speculative risk on the same footing as gambling is not acceptable. This is known as analogy with a discrepancy (*qiyās ma' al-fāriq*).

Therefore, from an Islamic legal theory perspective, this qualifies as a proper *'illah* or *ratio decidendi* of a particular judgement as there is a missing link in the argument. This is known in Islamic legal theory as the co-extensiveness of the *'illah*.[23] A good example is the prohibition of wine drinking in Islamic law. The possible *'illah* for this prohibition might be the colour of the wine, taste of the wine, the origin of or the effect of the wine that is intoxication. The proper and accepted *'illah* is the intoxication though other attributes apply to wine but they are not relevant in inducing the legal judgement.

At this point, it is clear that a possibility of loss or gain, though this applies to both gambling and speculative-risk actions, is not conclusive evidence of their similarity because gambling creates risk (in order to gain) while actions of speculative risk carry the risk that is integral to them. Perhaps, the reason why speculative risk has not been admitted to the insurance practice is that it creates a large degree of uncertainty on the part of the insurance company. In other words, it is possible that insurance companies do not pay attention to speculative risk-types of actions as they perceive the whole insurance business merely from a commercial point of view instead of a jurisprudential point of view. Therefore, the failure to insure speculative risk is not because it is gambling but rather because it is not insurable at a reasonable price.

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[23] This means that the *'illah* must be co-extensive (*muttarid*) in a way that whenever the *'illah* exists, the rule of law must also exist. If not, it is called *al-kasr* or *al-naqd*, i.e. when one of the *'illah*'s properties is cancelled due to inefficiencies, and it becomes clear that the remaining property cannot induce judgement, the *'illah* is inflicted with *kasr* (breakage); the inability of *'illah* to produce a judgement, on the other hand, leads to refutation (*naqd*). See al-Basri (1964), Vol. 2, pp. 821-822.

The above contention becomes clearer when we look at the requirements of an insurable risk listed in books on conventional insurance. From the viewpoint of the *insurer*, there are ideally six requirements of an insurable risk.[24] These requirements are as follows:

1. The existence of a large number of homogeneous exposure units. The purpose of this requirement is to enable the insurer to predict loss based on the law of large numbers. If a sufficiently large number of exposure units are present within a class, the insurer can accurately predict both the average frequency and the average severity loss.
2. The loss should be accidental and unintentional; ideally, it should be fortuitous and outside the insured's control. This means that if an individual deliberately causes a loss, it should not be paid.
3. The loss should be both determinable and measurable. It must be a type of loss that is relatively difficult to counterfeit, and it must be capable of financial measurement. In other words, we must be able to set some value on the extent of it.
4. The loss should not be catastrophic. It must be unlikely to produce loss to a very large percentage of the exposure units at the same time. The insurance principle is based on a notion of sharing losses, and inherent in this idea is the assumption that only a small percentage of the group will suffer loss at any one time.
5. The chance of loss must be calculable. The insurer must be able to calculate both the average frequency and the average severity of future losses with some accuracy. This is

[24] Redja, op. cit., pp. 21-23. We have written 'insurer' in italics to show that the determining factor in arriving at these requirements is the interest of the insurer instead of any principle which is more justified from the theory of law perspective.

necessary so that a proper premium can be charged that is sufficient to pay all claims and expenses and yield a profit during the policy period.

6. The premium must be economically feasible. The insured must be able to pay the premium.

All of these requirements, without exception, tend to point to economic considerations rather than the theoretical framework of insurance principles. In other words, theoretically speaking, the insurance principle does not disallow the inclusion of speculative risk in the insurance coverage provided it complies with these six requirements. To put this contention on test, it would be appropriate to see how speculative risk is able to satisfy these requirements.

As for the law of large numbers, speculative risk could easily fit in as with the case of pure risk. For instance, if there are large numbers of investors who decided to invest in any stock market (in the approved Sharī'ah manner as far as *takāful* is concerned), then these investors could participate in a *takāful* scheme to mutually indemnify those participants whose shares have devalued subject to certain terms in the *takāful* agreement. The investment in the stock market also satisfies the second requirement, that is the decrease of the value of shares is always unintentional or accidental. One may argue that some investors may deliberately purchase shares from certain companies under a particular sector hoping that the value of the shares will decrease to be subsequently indemnified. If we were to accept this line of argument, then the logic of this argument would also strike the insurance on pure risk because the car driver who is insured under Motor *Takāful*, for example, may negligently cause the accident hoping to be compensated. Therefore, should we admit this line of argument, then all types of insurance would be questionable as the insured may misuse the *takāful* scheme for his own interest.

Having said that, one must not forget that the *takāful* scheme is governed by the same principles as insurance with regard to the granting of compensation, namely the insured cannot recover more than the amount of the value of his interest and also, his application is subjected to normal procedures of claim wherein negligence and moral hazard will be scrutinised prior to granting the compensation. The due investigation is necessary in both schemes, particularly in the *takāful* scheme as the *takāful* operator, apart from being a manager, is also a trustee to all participants. To conclude, there is no reason not to accept that speculative risk may also cause a loss that is unintentional as in the case of pure risk. Above all, the insurance indemnity as in the case of investment should not exceed the face value of the investment sum. It does not indemnify the expected profit, as the loss of profit is not detrimental to the insured. To insure the expected profit, for example, is beyond the aim and purpose of this paper because the very purpose of the insurance or *takāful* is to mitigate the burden of a few individuals by dividing it among its members and participants. To insure even the expected profit in investment activities would lead us to many Sharī'ah complications.

To further support the above argument, one may look at the classical practice of mutual financial assistance in Islamic history. We cite one example that is self-explanatory, namely that Islamic law does not distinguish between pure risk and speculative risk with regard to the need of protection or mitigation. Afzal al-Rahman reported that the merchants of Makkah used to have a scheme to compensate business-expedition losses and also those who suffered through natural hazards. He states:

> "Even before the Ministry of Muhammad the Makkan merchants had formed a fund to help the victims or survivors of natural hazards or disasters during their trading journeys to Syria, Iraq and other countries. It so happened that once, when Muhammad (peace be upon him) was engaged in trade in Makkah, a whole trading caravan was lost in the desert, apart from a few survivors. The managing board,

composed of the members of the contributory fund, decided to pay the price of the merchandise, including the value of camels and horses destroyed, to the survivors and families of those who perished in the disaster out of the common fund. Muhammad (peace be upon him), who was trading with the capital of Khadijah, had also contributed to that fund" [al-Rahman, Afzal (1979)].

This report explains that business journeys entail both pure and speculative risks. One may highlight the element of pure risk but one also cannot fail to note that business journeys are undertaken to gain profit. Therefore, there is a possibility of loss as well as of gain in business ventures. If we were to be strict on the principle of pure risk, which means a risk that does not entail either profit or loss, then insurance coverage cannot be given to this type of activity.

Among other requirements of insurable risk is that loss must be determinable and measurable. This is not an easy principle as some losses are difficult to determine and measure. The most obvious example is the Family *Takāful* scheme[25] either for death or disability. The loss consequential to the premature death of the insured or his disability or hospitalisation is not determinable and measurable in a strict sense. Nevertheless, the *takāful* scheme accepts that. Surprisingly enough, if we were to ponder on the loss in investment activities, that is speculative risk, we are certain that the loss is relatively more measurable and determinable as far as the face value of the investment is concerned.

Another requirement is that the loss must not be catastrophic and the reason given for this requirement was merely financial in nature. Therefore, this can be easily put aside because participants may agree to mutually contribute and mutually indemnify each other in one group against any natural calamity and catastrophic losses. The financial consideration of this principle becomes clearer when we

[25] A good example of loss that is not determinable or measurable under conventional insurance is disability-income policy. See Redja, op. cit., p. 23.

note that many books mention that there are two approaches available for meeting the problem of catastrophic losses: first, by recourse to reinsurance and second, by dispersing their coverage over a large geographical area.[26] It is clear by now that the reason for the inclusion of this requirement in insurable risk is based exclusively on financial and feasibility considerations. This requirement has nothing to do with the 'bona fide' legal principle. Therefore, under *takāful*, catastrophic losses could be insured from a legal point of view, though it may not be feasible due to the danger of high exposure to one big loss at one time.

While the fifth requirement resembles the third requirement, the sixth requirement is financial in character. We have dealt with the issue of calculation of loss and it seems to us that the calculation of loss is not a must and is not always possible. As for the feasibility of the premium or contribution, it ultimately depends on the participants' financial ability to contribute a high amount for high protection of risk. It is only fair to contribute a higher amount in order to protect oneself from a more serious risk.

6. INSURABLE INTEREST FROM AN ISLAMIC PERSPECTIVE

The principle of insurable interest, as previously explained, specifies that the insured must be subject to a loss or some other kind of harm to seek insurance against. To be enforceable, all insurance contracts must be supported by an insurable interest. The literature on insurance tends to suggest that the principle of insurable interest is necessary to prevent gambling, to reduce moral hazard and to measure the amount of the insured's loss.

This principle sounds very convincing but not in life insurance or Family *Takāful*. The question of an insurable interest does not arise

[26] Ibid., p. 23.

when one participates in Family *Takāful*. Under conventional insurance law, the law considers the insurable interest requirement to be met whenever a person voluntarily purchases life insurance on his life. This means that one can purchase as much life insurance as one desires and one can name anyone as beneficiary.[27] Before we look at the *Takāful* Act we can, by a simple contemplation, conclude that the principle of insurable interest, as defined under conventional insurance law, is *ab initio* irrelevant to the Islamic principles of *takāful* because the participant-cum-insured could not have any interest on his life. Once he dies, he will not lose financially or incur some other kind of harm. Therefore, the writer personally agrees with the position in the *Takāful* Act with regard to insurable interest in the case of Family *Takāful*. The *Takāful* Act does not require the element of insurable interest, as this is irrelevant.

The literature on conventional insurance gives an impression that the principle of insurable interest is important to prevent gambling. This contention remains unclear from an Islamic legal theory perspective. In other words, can a person participate in the Family *Takāful* while he is not the insured? The answer is negative but the basis of this answer has no relation to the principle of insurable interest. The contract is null and void because the *takāful* scheme would only allow *takāful* participation by a person who is the participant and the insured at the same time. Therefore, to participate in the *takāful* scheme on behalf of others is void *ab initio* from a contract point of view rather than from the principle of insurable interest point of view. Although conventional insurance does allow a person to purchase an insurance for his spouse, child, ward, employee, or a partner as an exception to the principle of insurable interest, Islamic law does not allow this practice. However, Islamic law would allow the inclusion of any name as the nominee

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[27] Ibid., p. 64.

according to certain principles of Islamic law.[28] Therefore, under Islamic law, a creditor may require his debtor to participate in Family *Takāful* in which the creditor is named as the beneficiary as a kind of security. However, it is not possible for any person, even the husband to participate in Family *Takāful* on behalf of his wife and to put his name down as the beneficiary. This would contradict the principles of Islamic law in *takāful* because the *takāful* contract is concluded between the participants themselves and therefore, a party who is neither insured nor insurer, is not eligible to participate in the *takāful* contract, be it in Family *Takāful* or General *Takāful*. Insurable interest is very restricted in *takāful* whereby the overriding principle is the contract requirements instead of interest consideration.

7. CONCLUSION

It has been argued above that both the principles of insurable risk and insurable interest are just the legacy of conventional insurance practice that have been developed through the centuries. In most cases, the basis for having these two principles as legal requirements is merely financial in nature and to some extent, influenced by the misconception with respect to the meaning of gambling.[29] Generally speaking, the notion of gambling in conventional insurance has been pushed too far. This is not surprising when one considers that gambling is a lawful transaction under the conventional legal system. In order to differentiate insurance from gambling, Western economists and insurance theorists have restricted the meaning of insurable risk and insurable interest just to make insurance distinct from gambling.

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[28] This is based on an opinion that all indemnity is basically a gift from the pool and therefore, can be given to anybody without any restriction. Based on another opinion, this gift, if it is to be given to a nominee, must be limited to the one-third rule under the law of will. The remainder must be distributed according to the law of inheritance.

[29] For more details, see Siddiqi, M.N. (1985) *Insurance in an Islamic Economy*, pp. 27-35.

In this context, it is worth highlighting the view of Shaikh Mustafa al-Zarqa. In his book on insurance, he has vehemently argued that insurance, even conventional, is in total contrast to gambling. Insurance, unlike gambling, gives peace of mind to the policyholders in the face of loss due to risks.[30] Although both gambling and risk involve uncertainty, the method of managing this uncertainty differs. Under gambling, the gambler hopes to gain from the loss of others. Also, though there is a transfer of wealth in gambling, that is from the loser to the winner, there is no creation of new wealth.[31] Whereas under insurance, new wealth is being added to society and, therefore, it is a value-added activity in contrast to gambling that adds no value.

The Islamisation process of commercial dealings is very much desirable. However, in this process, practitioners sometimes overlook the salient features of the Sharīʿah principle governing a particular contract which underlies the Islamisation process. This can be seen clearly in the Islamic banking sector. Many Islamic banks nowadays are comfortable with fixed income instruments which have passed the test of the Sharīʿah with regard to their validity. Examples of these instruments are *bayʿ bi thaman al-ājil* and *murābaḥah*. These two instruments have been used quite extensively but the basis of these two products, in terms of their pricing, is still the principle of cost of funds which is alien to the Islamic tradition. The cost of funds was introduced because the conventional banking system views money as a tradable commodity whereby the Base Lending Rate (BLR) became an easy reference to determine the price of money. The real niche of Islamic banking is in equity financing but this has not been ventured into. Thus, one finds it difficult to appreciate the value added of Islamic banking products compared to conventional banking as both work under the same purview, that is fixed income

[30] al-Zarqa, Mustafa (1984), pp. 45-46.

[31] For details on wealth creation and wealth transfer, see el-Diwany, Tarek (1997), pp. 100-122.

instruments. Until and unless we free ourselves from this approach, Islamic banking will always be overshadowed by conventional banking.

Similar to the above impression, the paper has argued that as far as insurable risk in concerned, there is no limitation whatsoever as the participants may eventually agree amongst themselves to help one another even if the loss resulted from speculative risk or dynamic risk. The discussion has shown that there is no fundamental objection to render all types of risk insurable. The objection is merely financial in character. This is supported by the introduction of the insurance scheme for investment and export credit that is managed by the Islamic Corporation for Insurance of Investment and Export Credit that is based in Jeddah. Under this facility, commercial risks covered are the buyer's insolvency, protracted default and non-acceptance of goods dispatched. The non-commercial risks include restriction of or delay in the transfer of payments; the imposition of import restrictions; war and civil disturbance. Under this facility, a number of Muslim countries have participated to mutually contribute and indemnify each other against the above-stated risks. Obviously, many of these risks are speculative in nature.

As for insurable interest, the paper has argued that insurable interest is secondary in evaluating the validity of any *takāful* contract. What are more important are the principles of contract that govern the action of a person who wants to participate in a *takāful* scheme. As the contract of *takāful* is concluded between the participants themselves, as both insured and insurers, then the question of a third party is irrelevant. Therefore, the practice of conventional insurance with regard to insuring one's spouse, one's minor children or wards, or a person on whom one is wholly or partly dependent is not compatible with Sharī'ah principles. In short, the foregoing discussion aims at establishing that Islamic *takāful*, would, on the one hand permit insuring certain risks that conventional insurance shuns, namely speculative or commercial risks, and would on the other hand prohibit certain life insurance that conventional insurance permits

such as purchasing an insurance for one's spouse, child, ward, employee, debtor or partner by nominating oneself as beneficiary.

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COMMENTS

*Mohammad Hashim Kamali**

This paper explores the hypothesis that Islamic law's perception of risk does not preclude commercial risk from the definition of insurable risk. The author has concluded that *takāful* insurance may therefore proceed with both commercial and non-commercial risk types. The basic theme that the author has developed and the conclusions he has reached are acceptable. Yet there are weaknesses in the approach that the author has taken to reach those conclusions. Notwithstanding the author's own affirmation that his analysis is based in Islamic jurisprudence, he has not mentioned some of the themes and concepts of Islamic jurisprudence that are evidently relevant for his research.

1. There is no reference in the paper to the Sharīʿah concept of *gharar* (risk-taking, uncertainty), which is the main theme and context of Islamic law pertaining to risk and risk-taking in the context of commercial transactions (*muʿāmalāt*). The author has nowhere mentioned *gharar*, nor has he explained why he has avoided mentioning it. His basic hypothesis seems to relate to this context, as Muslim jurists have discussed *gharar* almost exclusively in the context of speculative risk in commercial transactions, such as sales

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and partnerships, and hardly ever in the context of religious observances, or *ʿibādāt*. The notion of risk to life and health are also alien to *gharar*. *Gharar* in other words is a *muʿāmalāt*-based idea, and this is basically what the author is trying to say. One would have thought that the author's hypothesis is already a recognised feature of Islamic law pertaining to *gharar*, as *gharar* basically consists of commercial risk. The author seems to have conveyed this awareness into his hypothesis and yet he has not made any reference to *gharar*. I am, therefore, raising the question whether the author has actually tried to make a hypothesis out of a settled position?

It is possible that the author has deliberately stayed clear of bringing *gharar* into his discussion of *takāful*, on the basis that *takāful* is a cooperative proposition, one which is predicated mainly on mutual support and cooperation rather than on commercial gain. Even if this is the case, although the author has not said so, this would still not justify his total silence over *gharar*: what the author has actually tried is to prove that *takāful* may seek to protect a commercial interest. The author's view of *takāful*, in other words, is not confined to the cooperative model but tends to combine cooperation with commercial gain. The author has, thus, tried to show that unlike conventional insurance, which is confined to protecting a non-commercial interest, the *takāful* alternative extends to all types of risk, including personal, family, education and commerce, etc. Then it would have been in order for the author to include *gharar* within the purview of his research.

2. Another point of weakness in the author's research is that he takes the definition of risk and its classification, etc., entirely from the works of Western writers on insurance and then he applies the Islamic principle of cooperation or *taʿāwun* to that premise. The conclusion that he draws is that Islamic law does not confine the scope of cooperation to non-commercial risk but extends it to all types of risk. There is no objection to this and the discussion of risk

in the context of *takāful* should, indeed take note of the differential perception of risk in other contexts. Yet this valid purpose does not justify the author's approach to simply take his materials on the definition and types of risk exclusively from Western sources. One would have expected that in his definition of risk, speculation and hazard, etc., the author would have started his research in the context of Islamic law and then taken it from there to provide an alternative and comparative analysis of risk. Risk in the deliberation of Muslim jurists occurs in the context of commercial transactions such as *muḍārabah* and *mushārakah*, semi-commercial contracts such as *juʿālah* and *kafālah*, and non-commercial contracts and transactions that fall under the broad category of *tabarruʿāt*. Risk is a relevant theme in all of these, although in various proportions, and the whole outlook on risk changes in the area of *tabarruʿāt* as the idea of charity, cooperation and help overshadows the risk content of a particular transaction in this category. There is no discussion of any of these in the paper under review. The contract of *kafālah* in Islamic law is evidently based on cooperation and goodwill without financial remuneration. The guarantor (*kafīl*) obviously takes a risk over fulfilment of a contract or performance of an act on behalf of another person. This is an unmistakably relevant theme to *takāful*; even the words *kafālah* and *takāful* are rooted in the same verb form. One therefore wonders why the author has not even mentioned *kafālah*.

3. The author's use of *qiyās maʿ al-fāriq* in the context of speculative risk and gambling is questionable. For the author makes a simple statement as he writes "... to put speculative risk on the same footing as gambling is not acceptable. This is known as analogy with a discrepancy (*qiyās maʿ al-fāriq*)." Is this an analogy at all? The author has not identified the four pillars (*arkān*) of *qiyās* nor has he actually engaged in constructing an analogy. To make the point that the author has made consists of a conceptual distinction between gambling and speculative risk Is there a need for recourse to *qiyās*

ma' al-fāriq here? To say that "this is known as ... *qiyās ma' al-fāriq*" is, therefore, not accurate.

4. On two occasions the author issues judgements on certain types of transactions, neither of which is self-evident, nor adequately explained by the author. One of these occurs in a footnote where it is stated that "the writer is of the view that the sharing of the surplus under the *muḍārabah* principle is not permissible. Perhaps, the basis of the contract of commercial *takāful* must be (sic) changed into a *ju'ālah* or *wakālah* contract." What is the reason for this prohibitive judgement, and why is *ju'ālah* or *wakālah* preferable to *muḍārabah*? What about *kafālah*? Would that provide a suitable alternative?

This is an important issue which merits a fuller discussion and it is not really justified to treat it in passing in a footnote. Is there also not an element of inconsistency and discordance between what the author says here and the general hypothesis of his paper? The author is evidently bringing in commercial risk within the purview of *takāful*, on the one hand, and suggesting that *takāful* should not proceed over *muḍārabah* on the other!

Then, in the very last paragraph of his paper, the author distinguishes *takāful* from conventional insurance by saying that "*takāful* is concluded between the participants themselves, in the as both insured and insurers, then the question of a third party is irrelevant. Therefore, the practice of the conventional insurance with regard to insuring one's spouse, one's minor children or wards, or a person on whom one is wholly or partly dependent is not compatible with Sharī'ah principles." The author gives little juristic analysis for the sweeping position that he has taken. All that the author has done is to highlight a difference between *takāful* and conventional insurance, saying that the former occurs between two parties and a third party is not involved. This is then taken as the sole basis of issuing a negative judgement on a range of conventional insurance types to say that these are all incompatible with the Sharī'ah.

The author is well aware of the basic Sharī'ah principle of permissibility (*ibāḥah*) as he has actually invoked it to good purpose in the context of validating *takāful* coverage for pure and speculative risk. Since the basic purpose of insurance, even conventional insurance, especially in the non-commercial context within the family and in respect of "wards or a person on whom one is wholly or partly dependant ..." is cooperation, one would have thought that this too could be subsumed under *ibāḥah*, which the author has obviously chosen not to do so. If conventional insurance is unacceptable to the Sharī'ah, there may be reasons for it, but the author is, of course, not discussing those, nor has he relied on them as a basis of his judgement. Then it remains to be said that the author has not given an adequate reason for his judgement, and what he has given is lacking in substance.

COMMENTS

*M. Anas Zarqa**

1. OVERVIEW

The author has scrutinised the implications of the concept of *takāful* (or mutual surety, on which Islamic insurance is presumably built), with regard to a major legal principle on which modern conventional insurance is presumably built, namely the concept of 'insurable interest' and the related concept of 'insurable risk'. He concludes that the *takāful* concept would on the one hand permit insuring certain risks that conventional insurance shuns, namely speculative or commercial risks, and would on the other hand prohibit certain life insurance contracts that conventional insurance permits. Examples of the latter contracts include purchasing an insurance for one's "spouse, child, ward, employee, debtor or partner" and nominating oneself as a beneficiary. However, "under Islamic law, a creditor may require his debtor to participate in Family *Takāful* (life insurance) in which the creditor is named as the beneficiary as a kind of security".[32]

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* Adviser, *The International Investor*, Kuwait.

[32] The statement 'under Islamic law' in the above quotation, and elsewhere in the paper is too strong an expression. It is rather, the author's considered juristic view *ijtihād*.

Thus, we see that the author has given the concept of *takāful* biting teeth and has shown it to have significant practical consequences in the conduct of Islamic insurance. He has done so with clarity and skill. His thesis is novel and worthy of careful consideration, but I am not confident enough to endorse or to challenge his major conclusions. Rather, I shall comment on some key ideas and statements in his paper.

2. DO WE ALWAYS HAVE TO BE DIFFERENT?

I find myself uncomfortable with the author's assertion that "it is illogical and ironic for *takāful* to operate under the same purview and preamble as conventional insurance. It follows from this that it is unjustifiable that the perception of the issues of insurance be the same under the two schemes, namely conventional insurance and *takāful*. This, for several reasons in my view is an overstatement.

First, even though a majority of modern Muslim jurists consider 'commercial insurance' not permissible while mutual (cooperative) is, a vocal minority asserts that both are *essentially similar* and permissible.[33] According to this minority view, proprietary companies which have shareholders and mutuals which do not, are performing the same cooperative task in society. Mutuals achieve cooperation *directly* as the insured are themselves the insurers. While proprietary companies do the same *indirectly* because total premiums on the average have to cover total losses,[34] with the insurance company acting as intermediary. "In life insurance as in all other forms of insurance, it is not the insurer who pays for the losses, the insurer

[33] The late Shaikh Mustafa al-Zarqa is the most eloquent representative of this minority view. See his book: *Niẓām al-Ta'mīn*, 4th ed., Beirut: Mua'ssasah al-Risālah, 1994.

[34] Ibid., p.45.

is merely transferring pooled funds – the premium payments of all the insureds – to the beneficiaries".[35]

Secondly, the concept of cooperation (*ta'āwun*) in Islam is not confined to philanthropic activities but clearly encompasses profit-seeking activities that abide by Sharī'ah rules and are motivated by good intentions. Al-Sarakhsī the great Ḥanafī jurist, expressed it thus:[36]

> "The cultivator needs the labour of the weaver to get clothes for himself; and the weaver needs the labour of the cultivator to get food, and cotton from which to make clothes… Thus each one of the two, in tending fully to his labour, is actually helping others do good deeds and obey [God]. This falls under the Divine command: "help one another in furthering virtue and piety [5:2)."

Thirdly, contracts and social institutions that have developed in non-Muslim societies are sometimes acceptable Islamically with little or no modification if they meet the Sharī'ah criteria. For instance, jurists have long recognised that the *muḍārabah* contract "has been practiced during *jāhiliyyah* ('pre-Islamic period of ignorance' in Arabia) and approved in Islam".[37] The same can be said of blood money and *'āqilah*

Having said that, I must now balance the scales and concede that the author has a valid point, namely that we should not assume without careful consideration, that whatever goes under conventional insurance should also go under *takāful*. He has given ample evidence of significant differences between the two approaches to insurance.

[35] Dorfman, M.S. and Adelman, S.W. (1992) *Life Insurance*, 2nd edition, Chicago: Dearborn Financial Publishing, Inc., p.3.

[36] *Al-Mabsūṭ*, Vol. 30, p. 64.

[37] Ibn Rushd, *Bidāyat al-Mujtahid*, Vol. 2, p. 233.

3. THE PRINCIPLES OF INDEMNITY AND INSURABLE INTEREST

"The essence of insurance is indemnity."[38] This statement requires almost no qualification in all types of insurance except life. In life insurance the amount of loss associated with a person's death cannot be established in the same objective way as in property and casualty insurance. Thus, loss in life insurance is to a large extent valued by agreement of the contracting parties. Nevertheless life insurance companies recognise the rule of indemnity by (i) limiting the amount of life insurance purchased to bear reasonable relation to the amount of potential loss, and (ii) confining ownership of life policies only to the person or persons exposed to potential loss because of the insured's death. This is the principle of *insurable interest* that "keeps life insurance from being used for gambling or anti-social purposes such as promoting or inducing murder." (op. cit.).

The principle of indemnity has been well received by contemporary Muslim jurists who also consider it a major difference between insurance and gambling.[39] This leads one to conclude that it is the principle of indemnity that is of primary importance in all insurance, and it is partially recognised in the realm of life insurance by the principle of insurable interest. This seems a more convincing perspective than asserting, as our distinguished writer did, that "it is not an exaggeration to note that insurable interest has been perceived as the most important legal principle compared to other legal principles, namely principles of indemnity, subrogation and utmost good faith."

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[38] Dorfman and Adelman, p.3.

[39] See for instance al-Zarqa, op. cit., pp. 43-44 and 143-144.

CHAPTER 7

Latest Developments in the Western Non-Profit Sector and the Implications for Islamic *Awqāf*

*Murat Çizakça**

1. INTRODUCTION

1.1 Importance of the *Waqf* System for Islamic Economics

Charitable foundations constitute the primary instrument for the voluntary redistribution of income in an Islamic economy. These foundations are known in the Islamic world as *waqf* (pl. *awqāf*) or *ḥabs*. Whereas the latter term is used in North Africa, the former is known, with slight variations, in the rest of the Islamic world.[1]

A *waqf* is established when a privately owned property is endowed for a charitable purpose in perpetuity and the revenue generated is spent for this purpose. All over the vast Islamic world from the Atlantic to the Pacific, magnificent works of architecture, as well as

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[1] In the Islamic Republic of Iran, '*waqf*' refers to traditional foundations and the term '*boniyad*' refers to those whose corpus is constituted by the confiscated assets of the previous regime. *Boniyad* has now become a general term referring to any financial institution. I am grateful to Ali Yasseri, Vice President of the Iran Banking Institute, for this information.

a myriad of social services vitally important for society, have been financed and maintained for centuries through this system. The resilience of the system is indeed remarkable. It has been shown that many *waqfs*[2] survived for considerably longer than half a millennium and some, even for more than a millennium [Crecelius (1995), p. 260].

A crucial achievement of the *waqf* system was the fact that essential services such as health, education, municipal services, etc., were all provided in history at no cost whatsoever to the government. This has had many important implications. First of all, the *waqf* fulfilled the above-mentioned functions by voluntary donations made by the well to do. This meant a better distribution of income in favour of the poor. Moreover, this was achieved not through the usual method, i.e. redistributive taxation, but essentially through voluntary donations without any state coercion. Thus, *waqf* emerged as the most important *voluntary* institution for poverty alleviation in the Islamic world.[3]

By providing essential services to society at zero cost to the state, the *waqf* system can significantly contribute towards that ultimate goal of every modern economist; a massive reduction in government expenditure. This, in turn, leads to a reduction in budget deficit, lowers the need for government borrowing, curbs the 'crowding-out effect' and leads to a reduction in interest rates and, thereby, cuts out a major impediment for private investment and growth.[4]

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[2] Literally the plural of *waqf* should be *awqāf*. However, in order to make a distinction between the institution of *awqāf* and *waqf* properties, sometimes *waqfs* is used for the latter. This is increasingly being accepted as another plural for *waqf*. (Editor).

[3] The relative importance of *waqf* as an institution of poverty alleviation should not be compared with *zakāh*. This is because, while *zakāh* is an obligation, *waqf* represents a voluntary act.

[4] Those who prefer a welfare state to fight poverty in the Islamic world, must also face the consequences of their policy suggestions: budget deficits, high interest rates (with obvious consequences for an Islamic country) and low investment and growth. Such costs proved too much even for the rich Western countries unconcerned about *ribā* implications, and the welfare state could not be sustained. This led, in turn, to the rising importance of the non-profit sector, which we will examine in this paper.

Thus, it is due to the *waqf* system that essential services to society can still be financed even though government taxation is severely limited by the Qur'ān.[5] This is possible simply because these services have been provided in Islamic tradition not by the state but by *waqf*s, a fact that is confirmed by the 16th-century Ottoman budget studies which reveal that the entire government expenditure was limited to military spending [Barkan (1953)].

This has further implications: a lower tax burden means an enhancement in consumers' and producers' surpluses and a diminution in the 'dead-weight cost of taxes'. Consequently, lower taxes have a positive impact on aggregate production while at the same time reducing costs. Prices to the consumers come down and pave the way for non-inflationary growth [Wanniski (1975), pp. 49-50, fn. 4].

Finally, it has been shown that *waqf* completely solves the problem of the under-supply of public goods so often observed in conventional economies [Çizakça (1998), Bates (1995)].

To sum up, Islam encourages both the private accumulation of capital and its redistribution. The process of redistribution, however, is left to the Muslims themselves who are expected to endow their accumulated capital for the service of mankind.[6] The institution designed for this purpose is *waqf* and Islamic economic history demonstrates that *waqf*s have successfully fulfilled the function of capital redistribution [Çizakça (2000)].

Thus, in an ideal Islamic society envisaged by the classical sources of Islam, the state's role is limited to defence and all other services are supposed to be provided by private initiative through the *waqf* system. Needless to say, in such a system, the proper functioning of

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[5] For an argument that by restricting the tax base, the Qur'ān has conveyed a deliberate message to limit the size of the state see Çizakça (1998), pp. 46-47.

[6] The Islamic law of inheritance, which rapidly distributes accumulated family fortunes, should also be considered in this context. The relationship between the law of inheritance and *waqf*s is a complex one. [For further details see Çizakça (2000).]

*waqf*s is of paramount importance. This implies another important role for the state: to ensure that *waqf*s function properly. The state can ensure this by providing a well functioning judicial system and guaranteeing the property rights of *waqf*s.

2. WHY THE SYSTEM WAS UNDERMINED

2.1 *Waqf*s and the State

Islamic economic history provides substantial evidence that states have often violated the property rights of *waqf*s. This violation occurred, among other things, out of concerns of the governments that *waqf* lands were expanding at the expense of state owned lands and consequently, provisioning the masses with basic foodstuffs was being jeopardised.[7] It was for this reason that the Ottomans placed about 90 percent of all arable lands, suitable for grain production, under state control [Inalcik and Quataert (1994), p. 105].

This ratio, however, did not remain constant and tended to decline over time, i.e. the percentage of *waqf* owned lands always tended to increase. This is because certain powerful farmers and notables managed to convert the properties they were controlling into *waqf*s. Since it was possible to appoint themselves as the trustees of these *waqf*s and since a *waqf* is considered to be God's property, these individuals sought to protect their illegally acquired lands from confiscation. These *waqf*s established with usurped landed property belonging to the state, were considered to be unsound and, therefore, could be confiscated. Strictly speaking, ownership of the endowed lands (*rakabah*), continued to belong to the state. It was the tax revenue generated by this state owned property, which was endowed for charity by the permission of the Sultan [Akgündüz (1988), p. 424].

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[7] *Waqf* lands, like privately owned lands, must have responded to the market forces by shifting between cash crops and grain production. The state, however, wanted to ensure a regular supply of grain.

What followed was a constant struggle between the state and these *waqf*s with the state trying to confiscate and the *waqf*s mobilising the religious establishment in their support. Thus, confiscation was followed by re-establishment by accommodative rulers. These cycles, which lasted for centuries were disrupted during the 19th century and assumed an irreversible character during the 20th. What forces were then at play which changed the equation in favour of the state? To start with, the nature of the state had changed in the Islamic world. If we focus on the Ottoman Empire, recent research has revealed that the Ottoman state went through a process of transformation: whereas the pre-18th-century Ottoman state was 'accommodative' of the intermediate organisations between the state and the public, such as the *waqf*s, massive inter-state competition transformed the 19th-century Ottoman state into a totally different dimension. The state ended up being far less tolerant and accommodative of intermediate groups and institutions, which it began to consider as rivals. The 'modern' Ottoman state was, however, above all these groups and institutions and did not hesitate to eliminate them if it suited its purpose [Islamoglu (1998)]. It is due to these developments that the 19th-century centralisation was not followed by another cycle of decentralisation.

2.2 Western Influence

Furthermore, unlike previous centuries, when centralisation was basically initiated due to the demands of the domestic economy or the state, in this period another powerful factor was added: pressure from Western powers. This pressure, strongly felt during the Treaties of Paris, London and Berlin, was expressed bluntly in 1860 in response to the Ottoman government's request for a loan after the Crimean War: The abolition of the *waqf* system was among the conditions imposed by the British government [Öztürk (1995), p.192; Khayat (1962), p. 68].

At this point we must ask why the West was so involved in the *waqf* system and why it was so hostile to it? The West cannot be criticised here for applying double standards. After all, it should be remembered that it had already attacked its own system of religious charities previously. Thus, this was a case of projecting its own values on the ludicrous assumption that what is good for the West is good for the rest of the world. An assumption made even more ludicrous by the fact that these policies were eventually abandoned in the West, itself. Let us now examine why there was such hostility to the foundations and religious charities in the West.

The West considered its own foundations as well as *waqf*s as a '*dead hand*' or '*mortmain*'. The origins of this hostility have been traced all the way back to the late Middle Ages when the free towns tried to control the *mortmain* and limit the size of church property. The town councils created commissions to supervise charitable foundations. The establishment of new charitable institutions was subjected to the approval of these councils. These controls were enhanced during the Reformation when the state officially acquired the powers of supervision. But Catholic Europe was also going through the same process: a French Ordinance of 1543 declared that royal judges should supervise foundations and organise their administration if necessary. Another Edict issued in 1749 prohibited the founding of new chapters, colleges, even hospitals without a *lettre patent* from the king.

The French Revolution constitutes a turning point for the foundations. In France, in general, any *corps intermédiaire*, i.e. any independent organisation that stood between the individual citizen and the state was opposed. These organisations, it was believed, created a fracture in the unity of the nation. No wonder then that in the 1789 Declaration of the Rights of Man, the civil right of association is missing. Consequently, a French Statute of 1791 dissolved all existing foundations and confiscated their property. Napoleon took a significant step further and made the Penal Code a more repressive legislation:

> "Any association of over twenty persons, whatever their purpose, cannot be created without the government's agreement and must respect the conditions imposed by public authorities."

This legislation lasted throughout the 19th century, and the leaders of unauthorised associations continued to be punishable and were sued by the repressive system of the Empire [Archambault (1997a), pp. 27-29].

In Germany, Martin Luther was a great advocate of centralised charity. In Prussia, much influenced by France, the *Allgemeine Landrecht* of 1794 granted supervisory rights to the state and the question of whether a permanent legal entity such as a charitable foundation could be organised by the will of a private person was fiercely debated.

In England, monasteries were dissolved, a *Rule Against Perpetuities* was promulgated, and in short, ever since the Edicts of Henry VIII and the Elizabethan Poor Laws, a secularisation of charitable institutions was advocated and attempted.

The only exception to these developments was the United States where the liberals insisted that the promotion of public welfare should not be left only to the state. In America, rich individuals were regarded as being under obligation to devote a part of their wealth for public good and private foundations which served such purposes were regarded as charitable foundations and favoured by law [Coing (1981), pp. 271-82; Friedman (1973)]. Germany, where some foundations did flourish and the concept of subsidiarity was developed, can be placed between the two extremes: France and the United States.

To sum up, absolutist rulers of the Islamic world were now facing powerful European nation states, which were becoming absolutists themselves. In this universal atmosphere of absolutism whole societies were directly subjugated by the state and there was no room for intermediary institutions. Europe, which at this time believed in a state, directly capable of taking care of its population and jealous

of intermediate institutions, did not hesitate to impose its 'enlightened' values on the Islamic world. Arch-absolutists themselves, rulers of the Islamic world did not need much persuasion. It is because of a combination of all these forces that the nature of the Ottoman state was transformed from being 'accommodative' into 'neo-absolutist'.

The result for the *waqf* system was disastrous and a process of destruction started in the Ottoman Empire by subjecting all the previously autonomous *waqf*s to centralisation. The establishment of the Ministry of *Awqāf* and the centralisation of *waqf* management allowed the state to extensively interfere in *waqf* affairs. The establishment of the ministry had several negative repercussions. There were totally unexpected costs and the potential for corruption increased greatly.[8] But the greatest blow to the Ottoman *waqf* system was dealt in the Tanzimat Era, during the 1830s, thus indicating that the state had already begun to act against the system, on its own initiative, well before the external pressures had reached a climax in the 1860s. It was decreed that all the taxes due to the *waqf*s from the peasantry cultivating *waqf* lands were to be collected not by *waqf* trustees any more but by the treasury officials. By the year 1847 this rule was expanded so as to apply to all *waqf*s in the Empire without exception.

The importance of this decree lies in the fact that *waqf*s were now put at the mercy of the central authority. From then on, only a percentage of the total *waqf* revenue collected would be returned to the *waqf* system and the magnitude of this percentage was entirely at the discretion of the state. Moreover, the percentage continuously declined over time. Whenever the state needed urgent revenue, which

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[8] I argue here that the potential for corruption increases in direct proportion to centralisation. This is because, a corrupt trustee of an autonomous *waqf* can harm only a single *waqf*, but a corrupt official of the centralised system can inflict harm on thousands of *waqf*s. If this person is also vested with the authority to collect revenues due to the *waqf*s, the potential for corruption increases exponentially.

happened to be nearly all the time, the percentage was reduced even further. Thus deprived of its own revenues, Ottoman *waqf*s succumbed to neglect and were destitute. The Republic simply continued the process, which had been started by the Ottomans themselves during the Tanzimat Era and leaders of the Republic continued to be hostile to *waqf*s.[9]

3. DEVELOPMENTS IN THE WEST

It is ironic that while the leaders of Westernising Islamic countries, such as Turkey and Egypt, continue to be hostile to *waqf*s, and legitimise their attitudes as being 'modern' and 'progressive', their reference point, the West, has completely reversed its attitude. Disappointed by the dismal performance of the state sector in providing essential social services like health, education and shocked by the exorbitant costs of these state provided services, Europe has at last come to the realisation that Rousseau's concept of 'Social Contract' whereby, as Montesquieu reformulated, the state has to grant every citizen a decent livelihood, food, education and shelter was simply unattainable. Now, a massive transformation is on the way and led by the United States, the West has once again rediscovered the virtues of the so-called non-profit sector.

In France, the birthplace of positivism and enlightenment, the seeds of this about-face can be traced back to the 1848 Revolution and the so-called *Charte de la Mutualité* of 1901, which legalised the foundations once again. Influenced by Durkheim, the ideas of social solidarity and charity once again became respectable. The Rousseauian concept of eliminating all intermediate institutions between the state and the public has now been abandoned [Archambault (1997a), pp. 26, 36; and (1997b), p. 104].

[9] For details of how the Ottoman/Turkish *waqf* system was almost totally destroyed by the Republic during the 1930s, see Çizakça (2000) and Öztürk (1995).

These Western developments promise to have important implications for the Islamic world. This is because everywhere in the West new concepts and legislation have been introduced and the non-profit sector has been injected with much needed new dynamism. It will be argued in this paper that Muslims need to be aware of these latest Western developments and seriously contemplate if they can be of any use for the Islamic world. It goes without saying that the *conditio sine qua non* of institutional borrowing is that the institutions and rules to be borrowed must be in conformity with Islamic jurisprudence. Thus, studying recent Western developments in the non-profit sector must be done in two steps: (i) observation and identification of what actually has been introduced, and (ii) an assessment of whether these new rules and regulations are in conformity with the basic teachings of Islam. In the rest of this paper, this is the procedure we will adopt. We will do so in good faith and in the spirit of the following *ḥadīth*:

"A word of wisdom is the lost property of a believer, he can take it wherever he finds it, because he is more entitled to it."[10]

3.1 The Legal Context

Western countries in terms of laws can be broadly categorised into two legal systems: common law and civil law countries. The advantage of the common law system is that the right to associate is typically assumed to exist even in the absence of positive law explicitly permitting it. Because of this, common law countries are often considered more hospitable to the existence of non-profit organisations. In civil law countries, by contrast, no such inherent right to associate is acknowledged. Rather, such rights exist only to the extent that the law permits them.

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[10] *Sunan al-Tirmidhī* (1992), Chapter 19, *Ḥadīth* No. 2687.

In Islam, the right to associate to advance charitable ends, is more than a right, it is a pious duty. But when some Islamic countries abandoned the Sharīʿah and adopted European civil law, the pious duty to establish a *waqf* became a civil procedure subject to governmental approval. This needs to be corrected and the establishment of a *waqf* should not be subject to governmental approval. In the Islamic tradition a mere confirmation by the court used to suffice to establish a *waqf*.[11] We will address this issue in greater detail below.

3.1.1 *Incorporation, Limited Liability and* Muḍārabah

One of the most important innovations in Western law has occurred in the field of incorporation. A non-profit association or foundation may be established as incorporated or unincorporated. In the former, a formal legal person status is granted to the foundation by some governmental body. The great advantage of corporation is that it provides limited liability to the directors or officers who act on behalf of the corporation from claims against the corporation. In case of litigation, the liability of these officers is limited to the assets of the association. In unincorporated associations, which can be established without obtaining government permission, liability is not limited.

The nearest entity in the West to the Islamic *waqf*, is the Trust which exists in common law countries.[12] Whereas an association is an aggregation of individuals, a trust is an aggregation of resources entrusted to an individual for management in pursuit of some specific purpose defined by the donor. In some countries a Trust can obtain

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[11] In Turkey this tradition has been partially maintained: court confirmation is still the most important step. But, courts request the opinion of the General Directorate of *waqf*s before confirming [Ballar (2000), p. 1250].

[12] This is not surprising. There is substantial evidence that the formation of the Trust law in England was strongly influenced by Islamic *waqf*s. [See Gaudiosi (1988), pp. 1231-261.]

legal personality without resort to government but in others, a Trust has no legal personality and the trustees remain legally at risk. In civil law countries, the nearest entity to the Islamic *waqf* is the foundation. Like the trust and *waqf*, it has an endowment of its own. In most civil law countries, government approval is needed to set up a foundation.

In classical Islamic law, the legal personality of a *waqf* is controversial. The Shāfiʿīs and the Mālikīs approve of bequeathing a mosque. Thus, they consider a mosque as a legal person that can possess. Karaman, based upon *Radd al-Muḥtār*, on the other hand, has argued that although not called as such, the concept exists among the Ḥanafīs as well [Hatemi (1979), p. 57].

In any case, the Western concept of legal personality was introduced into Islamic *waqf*s when certain countries like Turkey and Egypt adopted European civil law during the course of the 20th century. The 1935 *waqf* law in Turkey and Law No. 32 of 1964 in Egypt, both recognise that *waqf*s possess legal personality [Hatemi (1979), p. 57; Salamon and Toppler (1997), Chapter 7]. Since these countries have adopted the civil law of continental Europe, the common law concept of incorporated trust, i.e. limited liability for the *mutawallī*, has not been introduced. It is proposed here that this concept should be introduced into Islamic *waqf* law.

Introducing the principal-agency relationship, another Western concept currently very popular in micro-economic theory, within a framework similar to the classical Islamic *muḍārabah* partnership, would solve an age-old problem. This is the lack of interest and dynamism on the part of the *mutawallī*. There is a huge amount of archival evidence about disinterested *waqf* managers doing great harm to *waqf* property in Islamic history. Obviously, honest managers should be adequately compensated for their efforts. We have not been able to observe a consistent Western procedure on this issue: some laws permit the payment of fees to board members, some do not [Salamon and Toepler (1997), pp. 30-31]. The same goes for the payment of salaries to the employees of non-profit organisations.

Providing so stipulated by the founder, classical Islam permits the payment of salaries to the *mutawallī* – a fact supported by archival evidence. But what we are proposing here is a more advanced form of remuneration. Considering the *waqf* with legal personality as a principal, and the *mutawallī* as a *muḍārib* (agent), and allocating for the latter a percentage of the total revenue (not profit), we believe, would provide much needed dynamism into the *waqf* system. The trustee, *mutawallī*, cannot be assigned a percentage of profit, as is the case in usual *muḍārabah* arrangements. This is because, the *waqf* does not generate a profit in the usual sense and the difference between the total revenue and total cost is either added to the capital of the *waqf* (*corpus*) or immediately spent for the purpose of the *waqf*. Thus, since *waqf* is not a profit, but a total revenue maximising institution, we propose the payment of a share of the total revenue to the *mutawallī* who would thus be motivated to maximise it. Under these conditions the *waqf* would have the following condition:

$$TR = TC + \alpha TR$$

where TR is the total revenue generated by the *waqf*, TC is the total cost comprising administrative costs plus all the payments made for the purpose, and αTR is the share to be paid to the *mutawallī*.

Obviously, α is not fixed and will be determined by mutual agreement between the *waqf* and the *mutawallī*. Moreover, only successful *mutawallīs* should have their contracts renewed. The decision whether to renew the contract should be taken by the beneficiaries and the *waqf* board. One of the most important and persistent problems of *waqf*s in history was the long-term tenure of the *mutawallīs*. In the *waqf* of the future, *mutawallīs* should not be granted tenures of more than two years and the renewal of their contracts should be subject to their able management.[13]

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[13] This point was originally made by Monzer Kahf at the Third International Conference on Islamic Economics and Banking convened in Kuala Lumpur in 1992.

3.1.2 *Public Benefit Criterion*

Western law has gone to great lengths to define the concept of public benefit. The concept is of considerable importance due to the fact that trusts and foundations enjoy substantial tax breaks and public support. It is, therefore, generally, argued that only those institutions with clearly public benefit purposes should be granted such privileges.

Most common law countries have adopted the preamble to the *Charitable Uses Act of 1601* of England for this purpose. This otherwise very detailed preamble was later generalised in 1891 and public benefit was categorised as follows:

1. Relief of poverty.
2. Advancement of education.
3. Advancement of religion.
4. Other purposes beneficial to the community.

This English concept of charity has been directly borrowed by the United States and the US Tax Code refers to these categories before granting tax-exempt status to a trust or foundation. Once confirmed, such tax-exempt institutions are known as IRC 501 C (3) organisations.

Islamic law would have no objection to these categories. This is because these categories have already been mentioned by the Prophet Muḥammad (peace be upon him) way back in the 7th century. Consider the following *ḥadīth*:

"When a man dies, all his acts come to an end, but three: recurring charity (*ṣadaqah jāriyah*), or knowledge by which people benefit, or a pious offspring, who prays for him."[14]

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[14] *Ṣaḥīḥ Muslim*, (Kitāb al-waṣiyyah), Al-Kutub al-Sittah wa Shurūḥuhā, Chapter 3 (al-thawāb ba'd al-wafāt) *Ḥadīth* No. 14, (Istanbul: Cagri, 1992).

Juxtaposing the conditions of the *ḥadīth* and those of the preamble of the 1601 English Law indicates a remarkable similarity between the two. But, this does not surprise us, as it is well known that the English borrowed the Islamic tradition during the Crusades [Gaudiosi (1988)]. In short, the concept of public benefit is already well established in Islamic tradition. Moreover, there is a huge amount of precedence. Consequently, what is a difficult issue in the West, i.e. the question of what constitutes a charitable act, does not even arise in Islam.

3.1.3 *Conditions for Recognition*

There is a bewildering variety of conditions imposed by various Western states before a foundation or trust is recognised by a government and is granted tax-exempt status. Japan constitutes the worst case: a Japanese foundation must obtain permission from each ministry that happens to have authority on the field to which the foundation wants to contribute. Such permission can be denied if a ministry feels that there is no need for a foundation in that field. Obviously, such requirements can have a chilling effect on the growth of non-profit organisations in a country [Salamon and Toepler (1997)]. This Japanese regulation is, therefore, completely irrelevant and undesirable for the Islamic world.

The opposite case can be observed in Germany where the principle of subsidiarity prevails. Unlike Japan, where it is the state which decides whether a certain service is needed to be provided by a non-profit institution, in Germany the principle of subsidiarity assigns priority to non-profit over the public provision of social services. This principle emerged out of a vicious sectarian conflict in Germany between Protestants and Catholics. Prussian Catholics, who were undermined by rising secularism and Protestant hostility, embraced the Pope's encyclical *Qudragesimo Anno* (1931), which insisted on the priority of individual compassion and solidarity over the state-

organised assistance and public welfare programmes. In short, the state's role in welfare was supposed to be only a 'subsidiary' one. Eventually, the principle of subsidiarity of public welfare became the most influential counterweight to state-centred ideas of welfare provision [Anheier and Seibel (1997), p. 135].

Obviously, the German principle of subsidiarity is much closer to the Islamic concept of *waqf*. But what is far more important as a policy formulation is the way subsidiarity is applied in day-to-day life. As a matter of principle, the German state does not provide a social service in a certain locality if that area is adequately served by a non-profit organisation. Thus, subsidiarity has evolved into a superb principle of cooperation and division of labour between the state and the non-profit sector in the provision of social services. The concept of subsidiarity has recently been embraced by other Western countries and evolved into new dimensions of cooperation between the state and non-governmental organisations (NGOs).[15] This is best observed in the field of international aid. Nowadays a growing share of development spending, emergency relief and aid passes through them. Between 1990-1994 the proportion of the European Union's relief aid channelled through NGOs rose from 47 percent to 67 percent. The Red Cross estimates that NGOs now disburse more money than the World Bank [*The Economist* (Jan. 29th-Feb. 4th, 2000), p. 25].

The modern Islamic world may find it difficult to go back to the 16th-century Ottoman policy of zero government provisions of social services, mentioned earlier. Given that it may be both unrealistic and undesirable to push back the state completely out of the provision of essential services, the German concept of subsidiarity, which avoids a duplication of efforts and ensures a clear division of labour between the state and the non-profit sector, appears to be a useful idea to borrow.

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[15] Most NGOs are organised as trusts or foundations, hence their relevance for us.

3.1.4 *Capital*

Another condition often imposed by Western governments on trusts and foundations is a minimum capital requirement. The United States, once again, has the most liberal attitude in this context. Rather than imposing an absolute figure in dollar terms, the American government insists that a non-profit institution pays out for non-profit purposes an amount equal to a stated percentage of its assets. The purpose behind this rule is the risk that individuals will abuse the concept of foundation to gain tax advantages while essentially operating a private business rather than a true non-profit organisation.

Concerning the form of capital, this can be either real estate or movables, (cash or securities). Such foundations, the so-called *Hauptgeldstiftung* or *Kapitalstiftung*, were known and legal in Germany by the 14th century [Çizakça (1998), p. 53].

In the Islamic world, on the other hand, the form of *waqf* capital has been a highly controversial issue. Ottoman jurists, for instance, debated the legality of the so-called cash *waqf*s, i.e. *waqf*s whose capital was purely or partially of cash, for more than a century. This debate, known as the cash *waqf* controversy, could only be resolved by the direct intervention of the sultan. By the 20th century, however, the bulk of the Islamic world accepted the legality of cash endowments [Çizakça (1995), (1998), (2000)]. This is a welcome development which has also led to *waqf*-joint stock company linkages, to be discussed below. In Turkey, Sudan, Iran and Egypt cash *waqf*s can now be established, or possess, shares of joint stock companies and, thus, enjoy sustained profits [Çizakça (2000)].

3.1.5 *Registration*

Another condition for recognition by the state as a non-profit institution is the requirement that such an organisation must register with a governmental authority. All civil law countries make this demand. In common law countries, by contrast, the organisations

that fit the requirements of the law are assumed to be valid non-profit organisations unless challenged through established legal procedures. Once again, common law practice is closer to classical Islam, which does not demand registration with a central authority. In classical Ottoman practice, the *waqf* founder registered his *waqf* with the local *qāḍī* and was not involved with any higher authority. The requirement to register with the central authority (Ministry of *Awqāf*) was introduced as late as the 19th century under Western influence.

Recently, however, even in common law countries, non-profit organisations have started to register with a central authority. This is because tax-exempt status is granted only to centrally registered foundations/trusts. Even more importantly, such central registration allows the donors to deduct their donations from their income tax liabilities. Thus, the distinction between common law and civil law countries, as far as registration is concerned, is rapidly diminishing.

Another important issue concerns the duration of registration. That is to say, whether registration should be granted permanently or for a limited period, with the right to renew. While the latter provides a regular check on the compliance of organisations with their originally stated mission, the drawback is that it can give government authorities the opportunity to exercise inappropriate political control.

In classical Islam, since registration is done with the local authority, the *qāḍī*, on a permanent basis, the central authority has no right to check on compliance. The compliance check is done, rather, by the *mutawallī* himself and the beneficiaries. If the original purpose has become irrelevant, Ḥanafī law allows the *mutawallī* to change the purpose of the *waqf*. In short, provided that the founder has stipulated so in the *waqf* deed, the purpose of the *waqf* can be changed by the *mutawallī* himself and no central authority decision is needed [Akgündüz (1988), pp. 194-6]. The same concept is known in England as *cy pres*. On the other hand, if a *mutawallī* begins to ignore the original purpose of the *waqf*, the beneficiaries can always bring the matter to the courts' attention.

3.1.6 *Tax Treatment*

Taxation of non-profit institutions constitutes one of the most complex and controversial issues in the West. It is generally argued that non-profit organisations are entitled to tax-exempt status because they perform functions that are supportive of central values that a government normally encourages. It is also argued that these organisations relieve a government of burdens it would otherwise have to bear. Tax treatment involves two sub-issues:

1. The treatment of the non-profit organisation itself.
2. The treatment of donations to these organisations.

English law is very clear: tax advantages are granted only to those non-profit organisations that serve exclusively charitable purposes, hence the importance of defining what is charitable, as stated above. Concerning the second item, governments can encourage donations by permitting the donors to deduct their contributions from their taxable income. Critiques charge that such incentives are undemocratic since they rest in the hands of private persons over how to allocate revenues that would otherwise come to the government in the form of taxes. Thus, the basic issue in the West is whether the interests of the donor come before the general interests of the public.

In the US, all types of non-profit organisations are exempt from federal income taxation, but contribution deductions are available only for contributions to the 501 C (3) charitable organisations. Deductions for contributions of roughly 10 percent of income for corporations and 50 percent for individuals are allowed by the US Tax Code [Salamon and Toepler, 1997]. Similar rules prevail in England. In France, however, the limitations are far more severe, and deductibility of contributions is permitted only subject to the approval of the Council of State.

In the Islamic world, *waqf*s were not taxed. Of the hundreds of 18th-century Bursa cash *waqf*s examined by this author, none paid any tax. Inter-*waqf* contributions were also 100 percent tax-exempt [Çizakça (1995)]. Modern Islamic countries, however, have imposed tax responsibilities on *waqf*s. The permission to exempt a *waqf* from taxes in Turkey can only be granted, as in France, by the Council of Ministers. Yet the Council is so reluctant to make this grant that out of a total of 4472 new *waqf*s, (i.e. those established during the Republic), only 167 were granted tax-exempt status [Aydin et al. (1999), pp. 34-35, 60].

Thus, in the field of tax exemptions also, the American position comes closest to that of classical Islam. We propose that modern Islamic countries should abolish all taxes that they have imposed on *waqf*s under the influence of French Civil Law. The modern equivalent of this policy exists in the United States, which possesses the most dynamic non-profit sector in the world. We also propose that inter-*waqf* contributions as well as all private donations to *waqf*s should be made 100 percent tax exempt.

3.1.7 *Business Activity*

The business activities of trusts and foundations constitute the most important innovation made in the Western non-profit sector. These business activities are categorised into two groups: related business and unrelated business. The former is commercial activity closely related to fulfilment of the basic purposes of a non-profit organisation. For instance, a bookshop that sells textbooks at a non-profit university is a related business. The same shop operated by a non-profit day care centre, on the other hand, would constitute an unrelated business.

In Islam, the nearest we come to these concepts are the shops attached to a mosque. These shops may be considered as unrelated businesses. The basic difference between the two types of

organisations is that whereas an unrelated business attached to a Western non-profit organisation is directly managed or at least controlled by the non-profit organisation, *waqf*s' involvement in the day-to-day management of these shops was limited to the collection of rents. There is substantial evidence, again from the Bursa cash *waqf*s, that the rents generated by these shops were never taxed.

This is in sharp contrast with the situation in the West where in most statutory schemes unrelated income is taxed in the same manner as the income of ordinary businesses. The rationale of this policy is that tax-exempt unrelated businesses of non-profit organisations would constitute unfair competition for tax-paying profit-based businesses. Australia employs the so-called 'destination principle' and exempts from taxation, income from any business activity – related or unrelated – so long as it is used for non-profit purposes. Thus, in this case, it is Australia that comes the closest to the Islamic tradition [Salamon and Toepler (1997)].

With the approval of cash *waqf*s in most of the contemporary Islamic world, the ground has been prepared for dynamic *waqf*-company linkages which may emerge either when a *waqf* establishes joint-stock companies, or when a major company establishes a *waqf*. Such linkages are of extreme importance because the *waqf*s can overcome, for the first time, their inherent inertia. This is because, whereas *waqf* revenues were traditionally limited to the fixed rents collected from the real estate, and these rents nearly always dwindled under inflationary conditions, a *waqf* possessing shares as its capital can enhance its revenues in direct proportion to the profitability of the attached companies. But this also means that such *waqf*s would also be more vulnerable to the conjectural fluctuations of the securities they hold. This is certainly true, and it is precisely in this context that another Western invention, modern portfolio management, would be so useful.

4. CONCLUSION

This paper started with the premise that the recent explosion of the non-profit sector in the West should have important implications for modern Islamic countries. The paper, however, has evolved into one of comparison of the classical Islamic law of *awqāf* with contemporary laws in the West. A comparison of the most recent developments in the West has revealed that common law countries pursue policies that are closest to the classical Islamic *waqf* law.

In this context, it is unfortunate that Westernising Islamic countries such as Turkey and Egypt have primarily adopted the civil law originating in France. This was the most hostile body of laws for foundations and was based upon Rousseau's 'Social Contract' and hostility towards intermediate groups. A reform of the *waqf* system in the contemporary Islamic world is absolutely necessary. It is argued here that before such a reform is attempted, the current laws of, particularly common law countries, should be critically examined. Such an examination reveals that the concept of subsidiarity leading to powerful NGO activity, incorporated cash *waqf*s enjoying limited liability and *waqf*-company linkages, appear to be the most promising forms. Some of these, particularly *waqf*-company linkages have already been introduced into the Islamic world by enterprising and devoted Muslims, such as the late Vehbi Koç of Turkey [Çizakça (1998), pp. 62-65]. Muslim countries wishing to reform their *waqf* systems may also wish to take into account such recent advances achieved within the Islamic world as well.

There is also room for imagination and institutional invention. For instance, the largest cash *waqf* ever recorded in history could be established in Saudi Arabia with relative ease. Reference is made here to the establishment of a pilgrimage fund in Makkah. If every pilgrim was asked to contribute even a modest amount to the fund, a cash *waqf* of gigantic proportions could be established. The *waqf* could be managed by an international board, possibly under the

auspices of the Islamic Development Bank, with the purpose of helping Muslims the world over. Part of the cash collected could also be invested in various *ḥalāl* projects and the proceeds be added to the *corpus*.[16]

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[16] This suggestion was originally made by Tariqullah Khan during a workshop held by the Iran Banking Institute in Teheran. Obviously, the institution in question would need to be designed in harmony with Saudi laws.

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COMMENTS

*Mohamed Ahmed Sakr**

The author has divided the paper into three parts. The Introduction deals with the importance of *waqf*, the bad effects of Western influence upon *waqf* and the benefit that Muslim countries can obtain from new developments concerning non-profit and voluntary organisations.

Waqf institutions have played a very important role in poverty alleviation. Through this system it becomes possible to supply enough public goods at zero cost to the state, thus cutting down government expenditure and budget deficit. Lower government expenditure means a lower tax burden. This leads to a positive impact on aggregate production with lower costs. *Waqf* also encourages the private accumulation of capital and the voluntary redistribution of capital.

The state, according to Çizakça, should provide legislative guarantees, independence and sanctity to ensure proper functioning of the *waqf* system. Unfortunately, the state often violates this sanctity. The Ottoman state squeezed *waqf* properties more and more during the 19th and the 20th centuries.

Hostility against *waqf* found more encouragement from the West, British imperial governments often abolishing the *waqf* system. The French Revolution and the spread of secularism produced more

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hostility towards voluntary institutions. We all know the conflict between the church and the state. Squeezing voluntary activities gives more power to the state.

Muslim governments followed suit. In several countries, Ministries of *Awqāf* were established to monopolise *waqf* affairs. The Ottoman Tanzimat during 1830-35 dealt a heavy blow to the system. Treasury officials became responsible for the collection of taxes (actually rents) from peasants rather than *waqf* trustees.[17] The state grabbed almost all the proceeds. Such measures meant that a very small fraction of *waqf* revenues were returned to the *waqf* institutions, resulting in the neglect and decay of *waqf* properties. This policy gained more momentum after the Attaturk Republic.[18]

The hostile attitude towards voluntary institutions has changed in the West. The ideas of social solidarity and charity are gaining ground once more. The Muslim world should take note of this change and benefit from such developments. An assessment should be made to see to what extent these rules and regulations are in conformity with Islamic Sharīʿah.

The author supports the idea of *waqf*s possessing a legal and independent personality. In fact the 1930 *Waqf* Law in Turkey and Law No.32 of 1964 in Egypt admitted such a concept. In this case, the *mutawallī* can be considered as a *muḍārib* with limited liability and the *waqf* supplying the capital. According to the author, such a partnership would motivate the *mutawallī* significantly and enhance the efficiency of the *waqf*.

In Germany and the US an institution that is accepted as offering public benefit is granted substantial tax breaks and public support.

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[17] The separation between *waqf* and the state is summarised in Ibrahim Ganem's paper (1998), "A Discussion dealing with *Waqf* and Development", *Al-Mustaqbal Al-ʿArabī*, Vol.9, No.235, pp. 101-107.

[18] For a detailed and comprehensive study covering the attitude of various governing regimes in Egypt from the past to the present towards *waqf*, see Ibrahim Ganem (1998), *Al-Awqaf and Politics in Egypt*, Cairo: Dār al-Shurūq.

The German principle of subsidiarity is very similar to the concept of a *waqf* foundation. The concept is being recognised in the West and close cooperation between the state and non-governmental organisations (NGOs), especially in the field of international aid, is being established.

The author discusses many new ideas. As for cash endowments, they are accepted now in the Muslim world.[19] As for registration, the purpose of the *waqf* can be changed by the *mutawallī*, if the founders leave room for this in the *waqf* deed. A decision is no longer needed from a central authority. As for tax, historically *waqf*s were not taxed. The American tax exemption method is the nearest in this regard. It is suggested that all forms of taxes imposed on *waqf*s should be altogether abolished. As for business activity, the nearest to Islam is Australia and the distension principle. Any business activity related or unrelated is exempted from taxation as long as it is intended for a non-profit purpose.

Now we come to examine this valuable paper and make some remarks. The statement, "thus the *waqf* emerged as the most important voluntary institution of poverty alleviation in the Islamic world", requires some clarification. The institution which was designed to combat poverty is of a compulsory nature, i.e. *zakāh*. Almost all forms of wealth and income are liable to pay their share to eradicate poverty.[20] Such an institution cannot be left to the vagaries of human nature, to give or not to give. The *waqf* system contributed much to cover so many areas; services, education, industry and other social needs. Elimination of poverty is included.

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[19] According to Radwan Elsayed, cash and stock *waqf* were known since the Mamluk Era and now there is full agreement on its acceptance. *Al-Mustaqbal Al-Arab*, Vol. 9, No. 235, 1998, p.125. See also Murat Çizakça (1998), "*Awqāf* in History and its Implications for Modern Islamic Economics", *Islamic Economic Studies*, Vol. 6, No. 1, p. 24.

[20] Murat Çizakça (1998), "*Awqāf* in History and its Implications for Modern Islamic Economics", pp. 56-67.

but not as its main function. Actually the eradication of poverty is one of the main pillars of Islam.

Reduction in budget deficits and the curtailment of counter-productive government expenditure is necessary. But the current high wave of globalisation and the uproar for limiting much of the role of government is not accepted from an Islamic point of view. At all times the state should look to the welfare and evolving needs of society. To be sure, the policies adopted should preserve growth, equity, technical progress, and the safety of the Muslim faith, the Muslim *Ummah* and the Muslim lands.

To reform *waqf* and increase efficiency, the paper emphasises the importance of changing the role of the *mutawallī*. He should become *muḍārib* in a *muḍārabah* partnership. I think this suggestion is highly dangerous. If the *mutawallī* is *muḍārib*, the very meaning of *waqf* will be gradually forgotten. The *mutawallī* influenced by a strong profit motive would be direct the whole scheme for his own interest. I agree with what the author calls classical Islam, which permits the payment of salaries to the *mutawallīs* but nothing more. The *mutawallī* can look for an outside energetic *muḍārib*. His basic role is to supervise, check and oversee all matters and to be sure that the *muḍārib* is working correctly and to the benefit of the *waqf*.

The paper rightfully observes the important role of non-governmental organisations in Western societies. This is best observed in the field of international aid. Perhaps one basic reason for the growth of NGOs in the field of international aid is the vigorous attempt of some Western governments to infiltrate Muslim countries under the cover of voluntary aid. Direct and overt involvement by Western governments is highly unpopular and sceptical. This dubious job is being done without much provocation.

I share with the author his belief that the invention of the Ministry of *Awqāf* was not in any sense in the interests of *awqāf* and should be abolished. On the contrary, it was the vehicle through which much damage has been done. Yet there is a need for a central agency to be

established for the affairs of *waqf*s.[21] An agency composed of freely elected representatives of donors and fully recognised by the state. Such an agency is needed for the harmonisation and division of labour between various activities, and for registration according to well-observed rules and regulations. If *waqf* is registered thus, it should be entitled to full exemption from taxes. Donors should enjoy the privilege of income tax deductibility for their donations.

Finally, I do emphasise once more the importance of the points made by the author and the contribution he is making to enable this very essential institution to regain its past glory. Indeed, Muslim societies are facing complex challenges and *waqf* activities can cope with many of these challenges.

[21] Mohammed Boudjellal (1999), "The Need for A New Approach of the Socioeconomic Development Role of *Waqf* in the 21st Century". Paper presented to the Conference on International Islamic Economics in the 21st Century, Kuala Lumpur, Malaysia.

COMMENTS

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This is an extremely interesting paper but a very difficult one to comment on. It is well structured and tightly argued. As someone not that familiar with secular laws of the West or knowledgeable about Islamic jurisprudence, my difficulties are compounded.

The importance of *waqf*s as a voluntary sector institution in the Muslim world not only in the past but also in the present can hardly be exaggerated. The author deserves applause for his effort in tracing the 'rise' and 'eclipse' of *waqf* as an institution in Islamic countries. His discussion of the legal aspects is illuminating and highly pertinent. He succeeds in driving home the point that a suitable legal framework is an imperative to ensure that *waqf*s continue to play an effective and meaningful role in Islamic communities.

While there are, as the author has pointed out, similar institutions in the West in the form of non-profit organisations based on the concepts of charity and altruism, a *waqf* is unique in the sense that it constitutes an act of piety that continues to earn the pleasure of Allah even after one's demise. This distinction should caution us against simply equating *waqf*s with secular equivalents.

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Secular laws governing non-profit institutions vary from country to country, as the author has clearly demonstrated. They range from an extremely 'hostile' or 'restrictive' body of civil law in France to fairly 'friendly' or 'liberal' ones in common law countries, especially Germany, the United States and Australia. It is most unfortunate that some Islamic countries, notably Egypt and Turkey, have adopted a set of laws, in the wake of Westernisation, that are very inimical or unsympathetic to the institution of *awqāf*. Ironically, some Western laws towards *awqāf*-like foundations are far more tolerant than those that prevail in countries that declare themselves as Islamic.

The plea the author seems to be making is that Islamic countries should take the cue from liberal laws prevailing in some Western countries if at all they consider it fashionable to Westernise. This, however, does not necessarily mean that the author is recommending that the Islamic world borrow those laws of the West that suit the needs of *awqāf*. There is no harm in adoptions that conform readily to Islamic values, which would amount to no more than a second-best solution. The first-best option is that Islamic countries design their own set of laws based on the vast Islamic literature including *fiqh* rather than copy something that exists elsewhere that comes closest to Islamic requirements under the guise of modernisation.

The purpose of enacting new *awqāf* laws is to protect and promote the institution of *awqāf*. We must draw on our past experience. The reasons why *awqāf* lost its earlier glitter were mainly that this institution was subject to abuse by custodians, which in turn called for state interventions that crippled it altogether. There is a need to protect *awqāf* from abuse of any kind and to promote it so that it can contribute to the welfare of the *ummah*.

However, it would be unrealistic to expect *awqāf* to play now the prominent role it played during classical times. The role of the state has changed dramatically. In classical days, as mentioned by the author, the state was primarily in charge of defence and not with the provision of services such as education and health. There is nothing

un-Islamic if the domain of the state is extended beyond defence. Over the centuries, the state has moved into territories that were traditionally handled by the voluntary sector.

Under present circumstances, it would be inadvisable for the state to relegate the provision of utilities, education, health care, social welfare, etc., entirely to the voluntary sector. The voluntary nature of *awqāf* itself limits its scope, capacity and outreach. At the same time, it would be imprudent for the state to expand its activities into realms that can be best handled by the private and voluntary sectors. Deeper state involvement has adverse implications in terms of increased taxes, budget deficits and public debt. The voluntary sector can help reduce the burden of the state. Thus, there is a case for the voluntary sector to play a complementary or supplementary role. In other words, the relationship between the state and *awqāf* is not one of competition but of cooperation in enhancing the welfare of the *ummah*.

While *awqāf* can complement the initiatives of the state, the latter is no substitute for the former. In this context, it is pertinent to note that when the Caliph 'Umar wanted to give away his fertile land to the state, the Prophet (peace be upon him) advised him to make a *waqf* instead. Thus, in Islamic polity, *awqāf* can coexist alongside the public sector, one reinforcing the other. Making a *waqf* is an act of *'ibādah* and, as such, the laws of any Islamic country should facilitate, and not thwart, the establishment of *awqāf*. Rather, the law should regulate, and not stifle, the management of *awqāf*.

Awqāf as a voluntary sector institution can play a very useful role alongside the exchange economy that operates for a price. It can handle areas that cannot be dealt with effectively by the private or public sector especially in the provision of goods and services, which are need-based, not demand-based.

The question of efficiency must not be overlooked. It is a fact that most *waqfs* lack good governance and efficient management. As the author has observed, disinterested *waqf* managers did much damage

to *waqf* properties in Islamic history. The author then invokes the *muḍārabah* concept so that the *mutawallī* takes on the role of *muḍārib*. This, he argues, will give the *mutawallī* the incentive to put the *waqf* to efficient use. I am not so sure. First, *muḍārabah* is about sharing profits, whereas *waqf* is a non-profit proposition. Second, the *mutawallī* is a manager, not an entrepreneur. Third, the efficiency of a *waqf* cannot be measured by the surplus it generates. The relevant yardstick is the output it produces and distributes. In a framework where maximisation of output (which does not necessarily mean minimisation of costs) is the primary goal, a profit-sharing *muḍārabah* mode can hardly be used. Output is maximised when average cost equals average revenue, which yields zero profits. The *mutawallī* therefore, has to be rewarded differently from what the *muḍārabah* principle suggests.

The paper sheds much light on the legal aspects of *awqāf*. The comparison of the classical Islamic law of *awqāf* with contemporary laws in the West is refreshing. No one would quarrel with the author on his call for a reform of the *waqf* system and his insistence that the reform must include a re-examination of *awqāf* laws. Such concepts as 'subsidiarity' and 'limited liability' found in the common laws of the West, as pointed out by the author, are worth examining.

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Islamic Economic Institutions and the Elimination of Poverty is the second of the two volumes based on papers presented at the Fourth International Conference on Islamic Economics and Banking held at Loughborough University, UK, during August 13-15, 2000. The book highlights the Islamic approach towards poverty elimination and the role played by some built-in institutions of the Islamic system in this respect. Papers included in the volume point out that Islamic institutions such as *zakah*, elimination of *riba*, *awqaf*, *takaful*, *irfaq* etc., play an important role in reducing poverty levels and improving income distribution. While each of these institutions can make a significant contribution towards the goal of poverty elimination, the combined impact of all will be much greater than their additive impact. The book presents both theoretical and empirical evidence to highlight the role of these important institutional arrangements in poverty elimination.